CURRENT CONDITIONS IN THE NATURAL GAS MARKET

HEARING

BEFORE THE

COMMITTEE ON ENERGY AND NATURAL RESOURCES UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

SECOND SESSION

TO EXPLORE CURRENT MARKET CONDITIONS UNDER EXISTING NATURAL GAS LAW AND THE RELATED REGULATORY STRUCTURE TO DETERMINE THE NATURE AND EXTENT OF ANY PROBLEMS THAT ARE OCCURRING, AND TO BEGIN REVIEW OF POSSIBLE SOLUTIONS TO THESE PROBLEMS

DECEMBER 13, 1982

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CURRENT CONDITIONS IN THE NATURAL GAS MARKET

MONDAY, DECEMBER 13, 1982

U.S. Senate,
Committee on Energy and Natural Resources,
Washington, D.C.

The committee met, pursuant to notice, at 10:10 a.m., in room 3110 Dirksen Office Building, Hon. James A. McClure, presiding.

Present: Senators McClure, Domenici, Wallop, Warner, Murkowski, Nickles, Johnston, Bumpers, Ford, Metzenbaum, and Melcher.

Also present: Howard Useem, professional staff member; and Elizabeth Moler, counsel for the minority.

OPENING STATEMENT OF HON. JOHN W. WARNER, A U.S. SENATOR FROM THE STATE OF VIRGINIA

Senator Warner [presiding]. Chairman McClure will be here shortly. He has asked me to open this hearing so we can accommodate our colleagues now present who will testify. A short time ago, I wrote the chairman as did other members of the committee and urged that these hearings be held.

I did so, I presume, like most of my colleagues after listening to a number of concerns voiced by the people of my State. Let me read one or two of the letters that I have received. The first letter is written from Richmond, Va.

> I would like to call your attention to the outrageous gas prices we have to pay to heat our homes. I do not get social security until next year and my gas bills have doubled. As it gets colder, the rich will get richer.

The second letter is from Woodbridge, Va., and I quote:

> In view of the monopolistic advantages the gas company enjoys, it seems ironic that they want to pass on the cost increases to already heavily burdened consumers who have no choice in the selection of utilities.
>
> If monopolies wish to have the rewards that are available in our free enterprise system, they must also accept the risk that goes with it. Please don't allow them to enjoy the best of both worlds—huge profits with no risks—at my expense.

While today's witness list does not include a great deal of consumer representation, I regret we have not had the opportunity to put more consumer representation on, I may have statements from industrial and residential consumers groups that I will put in the record.

I also hope this will be the first of several hearings on this subject and that there will be an opportunity for others to testify early next year.

In 1978 when the Natural Gas Policy Act was passed, I, like many of my colleagues present today, was not a member of the U.S. Senate. Because of the complexity of this act, I have reservations about Congress attempting to resolve rising prices on a piecemeal basis. I also am not convinced that the proposed remedies will have the intended results.

The NGPA appears to have so many problems that passage of the legislative modifications before this committee would be like giving a band-aid to a patient who requires major surgery. It is difficult to imagine that legislation passed in December, even with streamlined regulatory procedures, would result in lower gas prices in January or February of 1983.

In order for consumers to get any relief this winter, based on conversations I have had with both industry and other groups, it is likely that that relief will come in the form of voluntary steps by the industry to alleviate these hardships through renegotiation of contracts.

I discussed this possibility with the industry and intend to continue to pursue it with this hearing today and afterwards. As the committee begins its deliberations, let us keep in mind our overriding responsibility to assure adequate supplies of energy are available to the American people.

I am greatly distressed by the rising gas prices, but we must never lose sight of a much more disastrous possibility and that is if we strangle the industry, there could be no gas at any price. I will not look favorably on any proposals that would increase our dependence on foreign supplies of energy.

Finally, many of us are concerned about the Federal low income energy assistance. Over the weekend reports from my State indicate that we have run out of money, and we have many applications pending. I hope some of us may address this problem in the context of a continuing resolution.

[The prepared statement of Senator Warner follows:]

STATEMENT OF THE HONORABLE JOHN W. WARNER
DECEMBER 13, 1982
COMMITTEE ON ENERGY AND NATURAL RESOURCES

DURING THE CONGRESSIONAL ELECTION RECESS, AFTER LISTENING TO A NUMBER OF CONCERNS VOICED BY THE PEOPLE OF VIRGINIA OVER THE COST OF THEIR NATURAL GAS HEATING BILLS, I MADE A WRITTEN REQUEST AND SPOKE TO YOU ABOUT HAVING THE COMMITTEE ON ENERGY AND NATURAL RESOURCES CONDUCT A HEARING ON NATURAL GAS. THE PURPOSE IS TO REVIEW THE CURRENT CONDITIONS IN THE NATURAL GAS MARKET AND ITS EFFECT ON THE CONSUMING PUBLIC AND TO EXAMINE THE VARIOUS PROPOSALS TO MODIFY THE NATURAL GAS POLICY ACT.

LET ME EXPRESS MY APPRECIATION TO YOU AND COMMEND YOU, MR. CHAIRMAN, FOR TAKING QUICK, FORTHRIGHT ACTION TO SCHEDULE THIS HEARING ON SUCH AN EXTREMELY IMPORTANT TOPIC.

VIRGINIANS, FACED WITH DIFFICULT ECONOMIC TIMES, ARE DEMANDING AN EXPLANATION OF THE RAPIDLY ESCALATING GAS PRICES IN THE MIDST OF AN APPARANT GAS GLUT. IN WRITTEN CORRESPONDENCE TO ME AND IN PERSONAL CONVERSATIONS, THEY HAVE EXPRESSED A CONVICTION THAT THE LAW OF SUPPLY AND DEMAND IS NOT WORKING IN TODAY'S HOME HEATING MARKET, AND THEY WANT TO KNOW WHY.

I WANT TO READ EXCEPPTS FROM JUST A FEW OF THE MANY LETTERS I HAVE RECEIVED:

THE FIRST LETTER IS FROM RICHMOND, VIRGINIA. "I WOULD LIKE TO CALL YOUR ATTENTION TO THE OUTRAGEOUS GAS PRICES WE HAVE TO PAY TO HEAT OUR HOMES. I HAD TO TAKE EARLY RETIREMENT BECAUSE I LOST MY JOB. I DO NOT GET SOCIAL SECURITY UNTIL NEXT YEAR, AND MY GAS BILLS HAVE DOUBLED. AS IT GETS COLDER, THE RICH WILL GET RICHER. WILL YOU PLEASE DO WHAT YOU CAN TO HELP US?"

THE SECOND LETTER IS FROM WOODBRIDGE, VIRGINIA. "IN VIEW OF THE MONOPOLISTIC ADVANTAGES THE GAS COMPANY ENJOYS, IT SEEMS IRONIC THAT THEY WANT TO PASS ON THE COST INCREASE TO ALREADY HEAVILY BURDENED CONSUMERS WHO HAVE NO CHOICE IN THE SELECTION OF UTILITIES. THE COMPANY TOOK A BIG GAMBLE BY COMMITTING ITSELF TO THE HIGH PRICED GAS, AND NOW CONSUMERS ARE BEING FORCED TO PAY FOR SERIOUS MANAGEMENT OVERSIGHT AND MISCALCULATIONS.

"IF MONOPOLIES WISH TO HAVE THE REWARDS THAT ARE AVAILABLE IN OUR FREE ENTERPRISE SYSTEM, THEY MUST ALSO ACCEPT THE RISK THAT GOES WITH IT. PLEASE DON'T ALLOW THEM TO ENJOY THE BEST OF BOTH WORLDS - HUGE PROFITS WITH NO RISKS - AT MY EXPENSE."

THESE ARE JUST TWO OF THE MANY, MANY OPINIONS EXPRESSED BY THE CONSUMING PUBLIC OF VIRGINIA. THESE VIEWS ARE EXPRESSED ON A SOMEWHAT LIMITED KNOWLEDGE THAT THE GENERAL PUBLIC HAS OF THE OVERALL ECONOMIC PARAMETERS OF THE HOME HEATING ENERGY INDUSTRY. NEVERTHELESS, EVEN WITH LIMITED EXPERTISE IN THIS AREA, THESE LETTERS AND THE MANY OTHERS LIKE THEM MAKE RESPONSIBLE POINTS WHICH NEED TO BE EXAMINED AND RAISE SERIOUS QUESTIONS THAT NEED TO BE ANSWERED ON HOW THE PRICE OF HEATING A HOME IS DETERMINED.

WHILE TODAY'S WITNESS LIST DOES NOT INCLUDE A GREAT DEAL OF CONSUMER REPRESENTATION, I MAY HAVE STATEMENTS TO SUBMIT FOR THE RECORD FROM ADDITIONAL NATURAL GAS CONSUMERS -- BOTH RESIDENTIAL AND INDUSTRIAL.

I ALSO KNOW THAT THIS IS THE FIRST OF WHAT WILL BE MANY, MANY HEARINGS ON THIS SUBJECT, AND THAT THERE WILL BE AN OPPORTUNITY FOR THE LOCAL USER -- FARMER, CITY DWELLER, RURAL RESIDENT -- TO NAME A FEW -- TO TESTIFY ON THIS SUBJECT AS WELL AS THE ASSOCIATIONS AND LARGE CORPORATE INTERESTS.

IN 1978 WHEN THE NATURAL GAS POLICY ACT WAS PASSED, I WAS NOT A MEMBER OF THE SENATE, AND I AM TOLD BY MANY THAT I SHOULD COUNT THAT AMONG MY BLESSINGS. I AM AWARE THAT THE NGPA WAS A COMPROMISE TO WHICH AGREEMENT WAS REACHED AFTER YEARS OF ACRIMONIOUS DEBATE. IT IS MY UNDERSTANDING THAT THE NGPA WAS TO PROVIDE THE NEEDED GAS SUPPLY TO THE AMERICAN CONSUMING PUBLIC ACCORDING TO A PRICE FORMULA WHICH WOULD ALLOW THE GAS PRODUCER A REASONABLE RATE OF RETURN WITHOUT CAUSING THE CONSUMER UNCONSCIONABLE ECONOMIC HARM.

RECENT EVENTS CALL INTO QUESTION WHETHER THE GOALS OF THE CONGRESSIONAL DRAFTERS ARE BEING OBTAINED. THE PRICING OF ENERGY COMMODITIES IS A VERY DIFFICULT AND COMPLEX PROBLEM AS EVIDENCED BY THE PROTRACTED NEGOTIATIONS ON THE NGPA.

IT IS BECAUSE OF THIS COMPLEXITY AND SEVERAL OTHER REASONS THAT I HAVE RESERVATIONS ABOUT CONGRESS ATTEMPTING TO RESOLVE RISING PRICES ON A PIECEMEAL BASIS. I AM ALSO NOT CONVINCED THAT THE PROPOSED REMEDIES WILL HAVE THE INTENDED RESULTS. THE NGPA APPEARS TO HAVE SO MANY PROBLEMS THAT PASSAGE OF THE LEGISLATIVE MODIFICATIONS BEFORE THIS COMMITTEE WOULD BE LIKE GIVING A BANDAID TO A PATIENT WHO REQUIRES MAJOR SURGERY.

IN ADDITION, IT IS DIFFICULT TO IMAGINE THAT LEGISLATION PASSED IN DECEMBER, AND SIGNED INTO LAW EXPEDITIOUSLY, COULD, EVEN WITH STREAMLINED REGULATORY PROCEDURES, RESULT IN LOWER GAS PRICES AND CONTRACT RENEGOTIATIONS BY JANUARY OR FEBRUARY 1983 -- WHEN THE REAL CRUNCH WILL HIT.

ANOTHER RESERVATION I HAVE STEMS FROM THE FACT THAT THE CURRENT LEGISLATIVE REMEDIES BEFORE THIS COMMITTEE PLACE THE BLAME FOR RISING GAS PRICES SQUARELY ON THE SHOULDERS OF THE NATURAL GAS POLICY ACT.

I WOULD DISAGREE THAT THE NGPA IS ENTIRELY AT FAULT. THE RESPONSIBILITY FOR NATURAL GAS SUPPLIES AND NATURAL GAS PRICES RESIDES WITH ALL OF THE AFFECTED PARTIES -- NOT ONLY THE CONGRESS, BUT ALSO THE STATE PUBLIC UTILITY COMMISSIONS, THE FEDERAL ENERGY REGULATORY COMMISSION, GAS PRODUCERS, PIPELINES, DISTRIBUTORS, AND THE CONSUMING END USERS. TOGETHER, ALL MUST WORK TOWARDS THE GOAL OF PROVIDING RELIEF TO GAS CONSUMERS FROM UNREASONABLE, IRRESPONSIBLE ENERGY COSTS THIS WINTER.

IN VIRGINIA, OVER 30 PERCENT OF THE INDIVIDUAL HOUSING UNITS ARE HEATED BY NATURAL GAS. PRICES HAVE RISEN BY OVER 70 PERCENT SINCE 1978 IN THE NORTHERN VIRGINIA -- WASHINGTON METROPOLITAN AREA. IN MY OPINION, CONSUMERS ARE DOING THEIR PART TO HOLD DOWN THEIR COSTS BY VOLUNTARILY CUTTING BACK ON THEIR CONSUMPTION OF THE FUEL.

HOWEVER, MR. CHAIRMAN, WHILE WE, THROUGH THE LEGISLATIVE AND REGULATORY PROCESS, DO OUR VERY APPROPRIATE PART IN ADDRESSING THIS PROBLEM, THE NATURAL GAS CONSUMERS ARE DEMANDING RELIEF FROM FURTHER RISING GAS PRICES NOW. AND IN ORDER FOR CONSUMERS THIS WINTER SEASON TO RECEIVE ANY RELIEF, IT IS MY OPINION THAT THE NATURAL GAS INDUSTRY MUST VOLUNTARILY TAKE STEPS TO ALLEVIATE HARDSHIPS AND RENEGOTIATE CONTRACTS.

I HAVE DISCUSSED THIS POSSIBILITY AT LENGTH WITH VARIOUS REPRESENTATIVES FROM THE NATURAL GAS INDUSTRY AND HAVE RECEIVED ASSURANCES THAT THEY ARE IN FACT MOVING TOWARDS RENEGOTIATIONS, OR WILL BE IN THE NEAR FUTURE. SUN OIL HAS WRITTEN ME THAT THEY HAVE COMPLETED NEGOTIATIONS ON TAKE-OR-PAY PROVISIONS ON SEVERAL CONTRACTS WITH ONE PIPELINE, AND ARE NEGOTIATING NOW WITH SEVERAL OTHERS. EXXON HAS TOLD ME THAT THEY ARE TAKING SIMILAR INITIATIVES WITH SOME SIX PIPELINES AND MOBIL HAS TELEGRAMED ME OF THEIR CONTRACT RENEGOTIATIONS. COLUMBIA GAS TRANSMISSION COMPANY, WHICH SERVES MUCH OF VIRGINIA, HAS ALSO WRITTEN ME, INDICATING THEY ARE LIMITING THE PRICES PAID FOR NATURAL GAS BEING PURCHASED UNDER EXISTING CONTRACTS. ALL HAVE ASSURED ME THAT THESE VOLUNTARY ACTIONS WILL ULTIMATELY PROVIDE ECONOMIC RELIEF TO THE CONSUMING PUBLIC.

MR. CHAIRMAN, I ASK UNANIMOUS CONSENT TO INSERT IN THE RECORD COPIES OF LETTERS WHICH I HAVE RECEIVED FROM SUN OIL AND COLUMBIA GAS TRANSMISSION COMPANY, AND A TELEGRAM FROM MOBIL OIL.

I INTEND TO EXPLORE THESE VOLUNTARY EFFORTS AND OTHER POSSIBLE MEASURES IN THE HEARING TODAY, AND THROUGH CONTINUED CONTACT WITH PRODUCERS, TRANSPORTERS, AND DISTRIBUTORS. I WILL BE CLOSELY WATCHING TO SEE IF THE CONSUMING PUBLIC DOES IN FACT BENEFIT ECONOMICALLY FROM THESE AND OTHER EFFORTS.

I BELIEVE IT IMPORTANT TO EMPHASIZE TODAY THAT WE ON THIS COMMITTEE, AND IN THE CONGRESS, HAVE AN OVERRIDING RESPONSIBILITY TO ASSURE ADEQUATE SUPPLIES OF ENERGY ARE AVAILABLE IN THE UNITED STATES. I AM GREATLY DISTRESSED BY THE RISING GAS PRICES, BUT WE MUST NEVER LOSE SIGHT OF A MUCH MORE DISASTROUS POSSIBILITY --

NO GAS AT ANY PRICE. I WILL BE KEEPING IN MIND THE IMPACT PROPOSED ACTIONS BEFORE THIS COMMITTEE MIGHT HAVE ON DOMESTIC ENERGY PRODUCTION. I WILL NOT BE LOOKING WITH FAVOR ON PROPOSALS WHICH COULD INCREASE OUR DEPENDENCE ON FOREIGN SUPPLY.

FINALLY, I WANT TO STATE MY STRONG SUPPORT FOR FEDERAL LOW-INCOME ENERGY ASSISTANCE. AS FUEL COSTS RISE, IT IS THE RESPONSIBILITY OF THE CONGRESS TO ADEQUATELY FUND FEDERAL FUEL AID TO DISADVANTAGED AMERICANS. SATURDAY PRESS REPORTS INDICATED THAT NO ADDITIONAL APPLICATIONS FOR LOW-INCOME ENERGY ASSISTANCE WILL BE TAKEN IN VIRGINIA THIS YEAR. FACED WITH A 25 PERCENT INCREASE IN APPLICATIONS, THE COMMONWEALTH HAS ALREADY ACCEPTED ENOUGH APPLICATIONS TO DEPLETE ITS FUNDS.

IT IS MY INTENTION TO PURSUE THIS THOROUGHLY AT BOTH THE STATE AND FEDERAL LEVEL, TO FIND THE FACTS AND SEE WHAT CAN BE DONE TO ALLEVIATE THIS HARDSHIP ON VIRGINIANS.

MR. CHAIRMAN, THIS CONCLUDES MY STATEMENT EXCEPT TO EXPRESS MY APPRECIATION TO OUR WITNESSES FOR APPEARING BEFORE US THIS MORNING.

Chad J Bardone
Vice President
External Affairs

SUN

Sun Exploration and
Production Company
One Lincoln Centre
5400 LBJ Freeway
Suite 695LB 52
Dallas Texas 75240
214 233 0840

December 9, 1982

The Honorable John W. Warner
U. S. Senate
Washington, D.C. 20510

Dear Senator Warner:

In response to your request, Sun wants to assure you that we recognize the need to work with pipeline companies on take-or-pay and other contractual conditions to be sure that our gas can reach the market place. We have completed negotiations on take-or-pay provisions on several contracts with one pipeline and are negotiating now with several others.

Sun has been very active in studying the ultimate markets of its natural gas and we think that producers, pipelines, and distributors can resolve this take-or-pay matter.

Sincerely,

Chad J. Bardone

Chad J. Bardone

CJB/cw

cc: Senator James A. McClure

DEAR SENATOR WARNER:

MOBIL RECOGNIZES THAT SOLUTIONS TO THE PROBLEM WHICH CURRENTLY EXIST IN THE NATURAL GAS MARKET IN THE U.S. WILL REQUIRE CONSTRUCTIVE ACTION ON THE PART OF PRODUCERS. PIPELINES AND DISTRIBUTORS. IN THE SPIRIT OF CONSTRUCTIVE COMPROMISE COMMA MOBIL HAS BEGUN DISCUSSIONS WITH SEVERAL PIPELINE COMPANIES TO RESOLVE EXISTING TAKE OR PAY PROBLEMS. AGREEMENT WITH ONE PIPELINE COMPANY HAS BEEN REACHED AND DISCUSSIONS WITH TWO OTHERS ARE WELL ALONG.

MEETINGS WITH SEVERAL PIPELINE COMPANIES HAVE BEEN SCHEDULED DURING THE BALANCE OF DECEMBER TO CONSIDER ADJUSTMENTS TO EXISTING CONTRACTS.

THESE ADJUSTMENTS WOULD INCLUDE TAKE OR PAY ARRANGEMENTS AS WELL AS OTHER CRITICAL ISSUES.

THESE ISSUES ARE COMPLEX AND HAVE SUBSTANTIAL IMPLICATIONS FOR MOBIL COMMA THE PIPELINE COMPANIES COMMA THE FINANCIAL INSTITUTIONS WHICH FINANCE THE DEVELOPMENT AND DELIVERY OF NATURAL GAS AND FOR THE AMERICAN CONSUMER.

WE BELIEVE THESE ISSUES ARE BEST HANDLED BY NEGOTIATIONS BETWEEN THE PARTIES INVOLVED IN AN ENVIRONMENT CONTAINING AS FEW LEGISLATIVELY IMPOSED CONSTRAINTS AS POSSIBLE. PASSAGE OF ILL CONCEIVED AND POSSIBLY UNCONSTITUTIONAL LEGILATION ABROGATING CONTRACTS WITHOUT FULL UNDERSTANDING OF THE CONSEQUENCES FOR THE NATURAL GAS INDUSTRY COMMA THE FINANCIAL COMMUNITY AND THE AMERICAN CONSUMER COULD BE DISASTROUS.

SINCERELY, W. P. TAVOULAREAS
MOBIL OIL CORPORATION

COLUMBIA GAS
System

Richard A. Casall
Vice President

1982 DEC -6 PM 6:23

December 3, 1982

The Honorable John W. Warner
405 Russell Building
Washington, D. C. 20510

Dear Senator Warner:

On December 1, Columbia Gas Transmission, our Appalachian pipeline subsidiary, announced a program to reduce the price it pays for natural gas it delivers to the 71 retail gas companies it serves. This should help hold down or reduce the future cost of gas to consumers. A copy of the press release and a list of relevant questions and answers are attached.

This program, coupled with our efforts to negotiate lower take-or-pay provisions in existing producer contracts as well as our refusal thus far to pay such minimum bill charges to non-affiliated pipeline suppliers for gas we did not take delivery of, should help us to compete with alternate fuels during this difficult economic period.

Should you have any questions, please give me a call at 887-1604.

Very truly yours,

Attachment

Columbia Gas System Service Corporation, 1625 Eye Street, N.W., Washington, D.C. 20006

COLUMBIA GAS
Transmission

news release

FOR IMMEDIATE RELEASE

COLUMBIA TRANSMISSION INITIATES PROGRAM TO REDUCE GAS COSTS

CHARLESTON, W. Va. -- Columbia Gas Transmission Corp., a unit of the Columbia Gas System, has initiated a program to reduce the price it pays for natural gas and, thereby, hold down or reduce future gas costs to the 71 retail gas companies it serves.

The plan involves limiting the price paid for natural gas under new contracts and negotiating lower prices for gas being purchased under existing contracts.

W. W. Ferrell, chairman and chief executive officer of Columbia Transmission, said the action is "an effort to slow down the rise in consumer energy costs and to help keep natural gas competitive with other sources of energy in the marketplace. He also pointed out that declining sales due to the current recession and conservation have sharply reduced customer demand and, therefore, the need to obtain additional gas reserves at this time.

(MORE)

umbia Gas Transmission Corporation Communications Department
P.O. Box 1273, 1700 MacCorkle Avenue, S.E., Charleston, West Virginia 25325
For additional information, contact B. J. Polis (304) 357 2496

In the Appalachian Basin, Columbia Transmission will offer $4 per million Btu (approximately 1,000 cubic feet) for "tight sands" and deregulated Devonian Shale gas produced from wells completed after January 1, 1983. In addition, as a part of its continuing effort to reduce current gas costs, the company will offer a somewhat higher price for gas developed from new wells in these formations if producers agree to renegotiate a lower price in existing contracts. Columbia is now paying $5.42 per million Btu, the current maximum price for tight sands gas established by the Natural Gas Policy Act, for this gas.

For other new gas, Columbia Transmission will offer the maximum price established by the NGPA in January, 1983, for whatever category the gas qualifies. These prices will range from $2.72 to $3.53 per million Btu.

Columbia will not offer price escalation clauses in new contracts as is current practice, rather the contracts will be periodically reviewed with producers to determine if a price change is in order.

Columbia Transmission is not contracting for new supplies of high-cost gas in the Southwest and has not done so for more than a year. Bids are being made only on gas reserves still subject to NGPA ceiling prices provided delivery is deferred for two to three years.

(MORE)

Ferrell said additional meetings are being scheduled with representative producers in the Southwest to brief them on the growing competition natural gas is experiencing in the marketplace and to seek to reduce prices Columbia is currently paying for deregulated gas from wells deeper than 15,000 feet.

These negotiations are a continuation of meetings begun earlier this year, Ferrell said. "While we can't predict what their ultimate outcome will be, we want to make certain producers are fully aware of what is transpiring in the marketplace, the concerns our wholesale customers are expressing to us, and the impact higher prices are having on sales and consumers."

Columbia Gas Transmission is headquartered in Charleston, W. Va. It delivers more than a trillion cubic feet of natural gas each year to 71 retail gas companies that operate in Kentucky, Maryland, New Jersey, New York, Ohio, Pennsylvania, Virginia, West Virginia and the District of Columbia. These companies, in turn, serve 4.2 million homes, businesses and industries.

#

BP/336
821129

December 10, 1982

TELEGRAM

The Honorable John W. Warner
United States Senate
Russell Senate Office Building
Washington, D. C. 20510

Dear Senator Warner:

You asked for information on Exxon's discussions with interstate pipeline companies on the subject of reducing their take-or-pay exposure under existing natural gas sales contracts. At their request, we have met with most of our major interstate pipeline customers, including Columbia Gas, Southern Natural, Natural Gas Pipeline, Northern Natural, and United Gas. We have received written requests and held telephone discussions with others on this matter and additional meetings have been scheduled.

Detailed negotiations are underway with a few companies, and we are close to final agreement with one. Without divulging the details of these negotiations, we can report that the pipelines are generally seeking temporary reductions in take-or-pay volumes and broadened recoupment rights, although some innovative alternatives are under discussion.

Exxon is attempting to work with its customers towards mutually satisfactory solutions that recognize the individual situations of seller, buyer, field, and contract. We believe these discussions and negotiations will provide satisfactory solutions to the near-term excess deliverability problems of the interstate pipelines, and continue to oppose legislated "quick fix" attempts.

Very truly yours,

S. J. Reso

Shell Oil Company

Suite 200
1025 Connecticut Avenue, N.W.
Washington, D.C. 20036

Telephone: (202) 466-1405

December 13, 1982

Senator John Warner
United States Senate
405 Russell Senate Office Building
Washington, D.C. 20510

Dear Senator Warner:

In response to your general request for specific examples of what an individual producer of natural gas is doing in recognition of the fact that gas purchasers, with Take-or-Pay contractual obligations, are experiencing serious and unanticipated reductions in their ability to market gas, I sumbit the follwoing: specific examples of actions taken along with statements of corporate policy.

Trunkline Gas Company at High Island A-350 field (granted 15 MMcf/d reduction below contract minimum; annual Take-or-Pay obligation not affected.)

United Gas Pipe Line at High Island A-490 field (granted 11 MMcf/d reduction below contract minimum; annual Take-or-Pay obligation not affected.)

Lone Star at Galveston 102L field (granted 7 MMcf/d reduction below contract minimum; annual Take-or-Pay obligation not affected.)

Southern Natural at Grand Isle blocks 75 and 76 fields (contracts amended to reduce daily and monthly minimum takes for a six-month period.)

Transco/Columbia at Brazos blocks A-19, 20 and 23 field (field development plan revised delaying development of deep (high cost) reserves; maximum field deliverability greatly reduced; overall field life increased.)

El Paso Natural Gas: various fields (granted 28 MMcf/d reduction in takes; no exposure to 1982 annual Take-or-Pay projected.)

Michigan Consolidated: various fields (granted 14 MMcf/d reduction in takes; no exposure to 1982 annual Take-or-Pay projected.)

Montana-Dakota Utilities: Pavillion field (granted 4 MMcf/d reduction in takes; possbile exposure to 1982 annual Take-or-Pay projected.)

The above examples demonstrate that Shell is taking positive action in response to individual pipeline requests for relief from Take-or-Pay provisions of Shell's gas sales agreements in situations where the pipeline is experiencing difficulty in marketing the gas it has contracted to purchase. Shell will continue to meet the needs of its individual purchasers as appropriate. However, considerations must be given to requiring the pipelines to take ratably from all wells producing in a given reservoir, in order to protect the correlative rights of the producers in the field and prevent drainage from one well to another. It is also important to preserve takes of casinghead gas, or gas produced with oil, which must be flared if not taken into the pipeline.

At this time Shell expects only minor Take-or-Pay accruals for 1982, plus year-to-date and current reduced takes (from total maximum capability) amount to less that 10% of gas well gas and no oil well gas. In addition, new contract negotiations reflect little if any decrease in Take-or-Pay levles offered by pipelines. Nevertheless, we are convinced some pipelines problems are real and unavoidable. To that end, we are responding appropriately and meaningfully. Shell sees no reason to legislatively abrogate Take-or-Pay clauses in natural gas contracts. The consumer of natural gas is the real beneficiary of Take-or-Pay provisions in that they make possible the long-term financing arrangements, at favorable rates for pipelines that insures secure future sources of natural gas supplies.

Sincerely,

Jess Johnson
Vice President

Senator **Warner**. Senator Ford.

STATEMENT OF HON. WENDELL H. FORD, A U.S. SENATOR FROM THE STATE OF KENTUCKY

Senator **Ford**. Thank you, Mr. Chairman. I basically agree with the chairman's statement. The steam by which we proceed here could create more problems than it corrects. I know after study, and over the weekend, and recently the Post indicates there would be very little help prior to spring under any of the legislation being proposed, so we cannot help our constituents immediately.

I think it is better that we do the job right. We had hoped to have done that previously, but it does not now appear to work and the contracts, take and pay, are one of the areas which I think needs a great deal of effort. I look forward to the hearing and compliment my distinguished colleagues in the Senate for their interest and the pieces of legislation that they have introduced.

Senator **Warner**. The Senator from Ohio.

STATEMENT OF HON. HOWARD M. METZENBAUM, A U.S. SENATOR FROM THE STATE OF OHIO

Senator **Metzenbaum**. Mr. Chairman, I must say that I am disturbed by this hearing, because it comes in the closing hours of the session and at a time when the people in this country are facing a crisis. This Congress has had time in this special session to deal with a price fixers relief act, relief acts to keep people from going bankrupt, the Shipping Industry Act exempt from the antitrust law, change the laws with respect to the Capital Gains Act. Yet, we have not had time to do anything about the very pressing problem of how people are going to pay their gas bills this winter.

And, frankly, I think our actions are irresponsible. I am not one of those who believe that we cannot come up with a meaningful solution in a short period of time if we have the will to do so. We should have been tackling this problem months ago.

This committee had time for everything under the sun except for this issue. I think our failure to do so is an indication of our inability to meet our responsibilities to the American people. I might say further that most of the problem we face today regarding higher utility bills came about by reason of the passage of the NGPA in 1978. It is rather interesting to me that some of those on the other side who are now prepared to speak out with respect to the problems that high gas prices are causing, some were here, not all of them were here at that time, but the fact is that very few members on the other side of the aisle saw fit to oppose the passage of the Natural Gas Policy Act.

Of course, that act opened the door, created the problem. We were all told "deregulate, deregulate" it will do wonders for the Nation. Well, it did not do wonders. We were lied to about the subject. The fact is we were told that phased deregulation would cause price increases of 8 percent per annun. And in my own State of Ohio, East Ohio Gas Co., which serves more than a million customers in the northeast portion of the State, recently announced that consumers will find their bills will be 40 percent higher this winter than a year ago.

I need not explain to the members of this committee exactly what that means. Forty percent higher. Senator Brooke, no longer here, he voted against the NGPA. I mean he voted with us, as did Senator Javitz. But other than that there were very few Republicans who realized the problems the NGPA would create.

I am pleased to see that some on the other side of the aisle have now joined with me and have indicated their concern. However, the fact is that in Ohio there are 7,000 producing wells that have been shut-in, closed down by an interstate pipeline which is purchasing more expensive gas in other regions of the country.

Consumers in Ohio and throughout the Nation want relief from high gas prices and they want it now. They have a right to look to the administration for some leadership and the administration is unbelievably silent about doing anything to solve this problem. The only proposal forthcoming from this administration in this issue has been to cut funds for low income energy assistance by $500 million for the coming fiscal year.

That proposed cut comes on top of a 2-year freeze in funding the program at $1,875,000,000, even though prices have risen more than 50 percent during the past 2 years. The proposed cut by the administration shows, again, this administration is indifferent to the problems of people. It shows that they care not the slightest about people on low and fixed incomes, facing the cruel choice this winter of whether they have money to pay for food or fuel.

The proposed cut also shows this administration does not care whether the hypothermia deaths increase even further than last year's record level. Columbia Gas that serves almost half the State of Ohio reports that already this winter more than 5,200 people have been shut off because they cannot afford to pay their bills. The State of Virginia announced on Friday that the money it received from the Federal Government for energy assistance this winter is almost gone in the second week of December. The money was supposed to last until the middle of March.

According to the Washington Post, the Citizen Labor-Energy Coalition forecasts that nationwide the number of utility shut off will rise this year to 300,000, up by 40,000 from last year.

Yes, indeed, Mr. Chairman, the administration's proposed cut of $500 million for low-income energy assistance again shows how cruel and unjust and inhumane and unfair this administration's policies have been and continue to be. Each week, just as the chairman receives letters, I receive hundreds of letters from middle-income families expressing anger and frustration.

They recall all of the conservation steps they have taken at home and, yet, they find that their gas bill is still busting their budget. Small business person already troubled in this depressed economy complain of gas bills that are swallowing up what little money they are able to make.

Industrial users, particularly process gas users and feedstock users, watch as their ability to retool and compete internationally is eroded by the higher and higher cost of fuel for business caused by their higher gas bills. To all of these classes of customers, the administration offers nothing but more rhetoric about its commitment to accelerated phased decontrol, which can do nothing but raise gas prices even higher than they are today.

Let us not forget the fact that the President of the United States has consistently indicated that he believes we ought to have total decontrol of the price of natural gas but is not quite sure of the political timing and therefore backed off before the last election. Several members of this committee argue we should sit tight and not tamper with the Natural Gas Policy Act.

Mr. Chairman, the simple fact is that the NGPA is a disaster. When Congress passed that act in 1978 over the filibuster that Senator Abourezk and I conducted on the floor, the sponsors assured the Congress that gas prices would increase 8 percent annually. They lied. They knew better than that. They did not tell us the truth. They did not tell us the truth either that there was a glut of natural gas that was sitting waiting to be used and that they were holding it back from the marketplace.

Mr. Chairman, I say to you that the natural gas industry has not leveled with the American people and some of it will be here today asking for some relief from some of the problems they find themselves involved in because they entered into take-or-pay contracts. And I understand that. Several Members of Congress, including myself, attempted to work within the parameters of the act to hold down price increases. To date those attempts have proved frustrating.

In September of 1981 I intervened in two purchase gas adjustment proceedings at FERC. In these proceedings Columbia Gas asked the Commission to allow the pass through of almost half a billion dollars in higher gas costs, which translated into a 30-percent rate hike for consumers in seven States, including Ohio.

Columbia has been purchasing gas from itself, from its wholly owned producing subsidiary, at prices higher than it was paying other producers. Furthermore, Columbia has been signing new contracts for decontrolled section 107 gas from major producers in the Southwest at prices above $8 per thousand cubic feet, while at the same time it has been shutting in thousands of producing wells in Ohio and Appalachia where gas sells on an average for less than $3 per thousand cubic feet.

I argued that these new high cost gas purchases should be denied pass through, because they were excessive due to fraud, abuse and similar grounds and I thought the intervention would be dealt with impartially by the Commission. Instead, the chairman, Mike Butler, said that anyone who asked the Commission to deny any purchased gas cost under section 601C was simply asking the Commission to engage in a witch hunt.

A policy statement was then issued by the Commission that practically directed a finding for the pipeline in the case. Fifteen months later the case is still pending before an administrative law judge.

Senator **Warner**. Senator, might I ask how much longer you might be?

Senator **Metzenbaum**. About 5 minutes.

Senator **Warner**. We have already given you 12½. If each of us use that amount of time, we will scarcely get this hearing underway. I would hope the Senator would see fit to limit a good portion of that. Thank you very much.

Senator **Metzenbaum**. About 2 minutes.

Mr. Chairman, to make a point, the Commission has not met its responsibility any better than has the administration or this Congress. Mr. Chairman, I recognize there is little chance of getting any legislation passed in the final days of this session.

We should have been attuned to this problem many months earlier. Our failure to do so is not an adequate answer for the people of this country and certainly not an adequate answer for the people in my State. I believe that the sooner we get on about this business when we reconvene in January, the more we can serve the interests of this country.

I think we made a mistake in passing the NGPA and I think now it is a question of what kind of corrective legislation we can enact and see whether or not we can ameliorate the problem. I thank you.

[The prepared statement of Senator Metzenbaum follows:]

U. S. Senator Howard M.
METZENBAUM
of Ohio

Committees:
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FOR IMMEDIATE RELEASE
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OPENING STATEMENT BY SENATOR HOWARD M. METZENBAUM

BEFORE THE COMMITTEE ON ENERGY & NATURAL RESOURCES

December 13, 1982

MR. CHAIRMAN, today's hearing on the crisis facing natural gas consumers is long overdue. This committee should have tackled the problem of soaring retail gas prices during a supply glut many months ago. Now there is almost no time left in the lame duck session to enact legislation to address the acute pain millions of Americans are feeling in their pocketbooks every day.

In my home state of Ohio, the East Ohio Gas Company, which serves more than one million customers in the northeast portion of the state, recently announced that consumers will find that their bills will be 40 percent higher this winter than a year ago. This increase comes at a time of record unemployment and a depressed economy. It also comes at a time when 7000 producing wells in Ohio have been shut in by an interstate pipeline which is purchasing more expensive gas in other regions of the country.

Consumers in Ohio and throughout the nation want relief from high gas prices and they want it now. And yet to date the only proposal forthcoming from this administration on this issues has been to cut funds for low income energy assistance by $500 million for the coming fiscal year. This proposed cut comes on top of a two year freeze in funding the program at $1.875 billion even though energy prices have risen more than 50 percent during the same period.

This proposed cut shows that this administration cares not the slightest that people on low and fixed incomes will face the cruel choice this winter of whether to pay for food or fuel. This proposed cut also shows that this administration does not care whether hyperthermia deaths increase even further than last year's record level. In Ohio, Columbia Gas which serves almost half the state, reports that already this winter more than 5200 people have been shut off because they cannot afford to pay their bills. The state of Virginia announced on Friday that the money it received from the federal government for energy assistance this winter is almost give in the second week of December. The money was supposed to last until the middle of March, according to the Washington Post. The Citizen Labor Energy Coalition forecasts that nationwide the number of utility shutoffs will rise this year to 300,000, up by 40,000 from last year. Yes, indeed, Mr. Chairman, the administration's proposed cut of $500 million for low income energy assistance shows just how cruel and unjust and inhumane and unfair this administration's policies can be.

Of course, those onlow and fixed incomes aren't the only people being ravaged by the staggering price of natural gas. Each week I receive hundreds of letters from middle income families expressing anger and frustration. They recount all of the conservation steps they have taken at home, and yet they find that their gas bill is still busting their budget. Small businessmen struggling to stay solvent in this depressed economy complain of gas bills that are swallowing up what little money they are able to make. Industrial users, particularly process gas users and feed stock users, watch as their ability to retool and compete internationally is eroded by the higher and higher cost of doing business their gas bill creates. For all of these classes of customers the administration offers nothing but more rhetoric about its commitment to accelerated, phased decontrol, which would do nothing but raise gas prices even higher than they are today.

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Several members of this committee argue that we should sit tight and not tamper with the Natural Gas Policy Act. But, Mr. Chairman, the simple fact is that the N.G.P.A. is a disaster. When Congress passed this act in 1978, over my repeated attempts to defeat it, the sponsors assured the Congress that gas prices would increase between seven and twelve percent annually. We were told that the price for new gas supplies would be phased in gradually so that the average price would reach market levels in 1985 and there would be no distortions when price controls were removed. We were lied to. In reality, prices have been increasing at a rate of 25 to 40 percent a year -- more than 3 times as fast as promised. These skyrocketing increases have caused gas prices in recent months to rise above the price of alternative fuels in the industrial sector, which in turn has created another round of rate hikes for the remaining on-system customers who have been forced to absorb higher and higher portions of their retail distribution company's fixed costs.

Several Members of Congress, including myself, have attempted to work within the parameters of the act to hold down price increases. To date these attempts have proven frustrating. In September of 1981, I intervened in two purchased has adjustment proceedings at the Federal Energy Regulatory Commission. In these proceedings Columbia Gas Transmission had asked the Commission to allow the pass through of almost one billion dollars in higher gas costs, which translated into a thirty percent rate hike for consumers in seven states, including Ohio. Columbia had been purchasing gas from itself and its wholly owned producing subsidiary at prices higher than it was paying other producers. Furthermore, Columbia was signing new contracts for decontrolled section 107 gas from major producers in the Southwest at prices above $8 per thousand cubic feet at the same time it was shutting in thousands of producing wheels in Ohio and Appalachia, where the gas sold, on average, for less than $3 per M.C.F. I argued that these new high cost gas purchases and self dealings should be denied pass through because they were excessive due to "fraud, abuse, or similar grounds" under section 601 C of the act.

I thought this intervention would be dealt with impartially by the Commission. Instead, the chairman, Mike Butler, said that anyone who asked the Commission to deny any purchased gas costs under section 601 C was simply asking the Commission to engage in a "witchhunt". A policy statement was then issued by the Commission that practically directed a finding for the pipeline. Fifteen months later, the case is still pending before an administrative law judge. In the meantime, Columbia has been permitted to collect the entire $1 billion, without suspension, subject to refund.

This same commission, which sits on any attempt to hold down prices, has been quick to issue regulations designed to benefit producers. The Butler Commission has approved a 50 percent increase for gas drilled in three hundred feet of water. It was a similar increase for gas drilled between 10,000 and 15,000 feet and backed off only after I and seven of my colleagues protested during the rulemaking. These administrative attempts to accelerate prices are just a continuum of the activities during the previous administration, when a 100 percent increase was granted for tight sands gas.

Mr. Chairman, we can no longer let the N.G.P.A. play itself out. Congressional inaction, coupled with the massive abuses created by F.E.R.C. in administering the law, has led to a situation which is intolerable and unconscionable. In the present environment the only winners are the producers, which are reaping massive profits, and the interstate pipelines, which have been allowd to operate a risk-free industry. Everyone else is losing and losing big. According to one retail distribution group, letting the N.G.P.A. play out in its present form with contracts unchanged will cause utility loads to contract by 40 percent and residential rates to rise 350 percent over the next eight years. That is a disaster we simply cannot allow to happen.

I realize, Mr. Chairman, that there is little chance of getting any legislation passed during the final days of this session. Hopefully, today's hearing will form the groundwork for a series of hearings on comprehensive natural gas legislation in the first month of the next congress. However, I think it only fair to say that the gas issue is going to break wide open in January, whether the committee decides to address the matter or not.

Senator **Warner**. The Senator should know that within the administration circles and here in the Senate there are a group of us who are trying to encourage the Department of Energy, for example, to release a half a billion dollars now in an escrow account gathered through the oil pricing overcharge, which the Senator is familiar with. That could be released to immediately help augment these emergency funds. So I think there is some move to try and alleviate the problem.

Now, I would like to call on my colleagues in the order they are arriving, the Senator from Oklahoma.

STATEMENT OF HON. DON NICKLES, A U.S. SENATOR FROM THE STATE OF OKLAHOMA

Senator **Nickles**. I appreciate the opportunity to have this hearing to expose some of the dilemmas, challenges and problems that we now find ourselves in in the natural gas arena. I am hopeful in this hearing that we will actually get to the root of the problem, and, in my opinion, the root of that problem is past and present government interference in the marketplace.

I trust the testimony and discussion today will reveal how many of the bills that are now pending before this committee not only fail to address the root of the problem, but also fail to serve as a quick fix remedy. Rather than offer temporary relief, I believe that these measures which offer various price freeze proposals and proposals to alter private contracts would actually exacerbate our existing problem.

Quick fix legislation during this lameduck period will not really fix anything but rather would only worsen an already bad situation. Why? To begin with a freeze on wellhead prices will not produce the promised relief to the consumer because increased cost to consumers is the result of several factors. The numerous price categories that we find in the NGPA, I believe there are 23 or 25 different price categories for the same product, and also the fact that pipelines are moving a lot less gas are two such factors. Because pipelines move a lot less gas, they have to amortize those fixed expenses over less units and, therefore, the per unit cost is higher. This also is partly the fault of Federal regulation, because the regulation gurantees them a fixed return on their assets.

It is my opinion that today's problems are also the result of other acts that were passed in the 1978 era that we have heard a little about this morning, such as the Fuel Use Act which says you cannot burn natural gas. And if you are burning natural gas in industry thanks to NGPA's incremental pricing you have to pay a higher price for gas and, therefore, a lot of industrial customers have gone off gas.

Regarding the various contract alteration proposals which tamper with take and pay clauses and price escalator clauses, in my opinion these proposals would result in lawsuit after lawsuit in court and would backlog the Federal Energy Regulatory Commission. This would create greater uncertainty in a market already disoriented through overregulation.

I am a strong believer and protector of private contractual rights. I am concerned with the constitutional questions raised by the pending legislation regarding the taking of property without just compensation. I am also concerned that such tampering with contracts will result in the unreliability of future contracts, producer default, and bankruptcy under current contracts with lending institutions and the failure of producers to enter prospectively into any long-term contracts with pipelines that pipelines actually need in order to guarantee their supply.

I am sure that all of the members here are aware of the recent major bank failure in my State of Oklahoma. I think if we did move into contract alterations, as proposed by many of the bills before us, that we would actually see avalanche of bank failures, those banks that have dealt heavily in the energy business.

So I think we will need to move slowly, prudently and thoroughly discuss this problem. I hope this committee will begin today, but I certainly don't think we have time to move forward with just legislation in this lameduck session.*

Thank you, Mr. Chairman.

Senator **Warner**. Thank you.

Senator Wallop.

STATEMENT OF HON. MALCOLM WALLOP, A U.S. SENATOR FROM THE STATE OF WYOMING

Senator **Wallop**. Mr. Chairman, I will put my statement in the record, but I would just like to echo some of the things Senator Nickles said. One of the cruel hoaxes about these proposed bills is that they will not do much for prices, because you cannot reduce the price of gas in a half full pipeline, which is the principal cost that people are bearing now, plus the cost of operating the pipeline.

If you have a pipeline that is just half full you are going to have bad cost distortions in the marketplace. What we really need to do is find the means to get the pipelines full and that means doing something about inducement of the sale of gas.

I worry, however, about going too fast on this. I fear that you provide people with hopes that will not materialize, that cannot materialize and then out the other end of it, we will have done something really nasty. We will have created by Government policy yet another shortage.

And, Senator Metzenbaum, people did not lie. There was a shortage and the new gas deregulation did provide the incentive to go explore it, did provide exploration in my State of Wyoming, and did provide a tremendous supply of gas. These take or pay contracts, however, were not the fault of the producers; these were the fault, if fault should be assigned, of pipeliners and distributing companies who thought that we were running out of natural gas, and they ended up taking gas at any price.

What we have to do now is find some means of continuing the exploration that has taken place, so that we do have a supply, and put into balance some of the gas and energy policies that are so lacking right now.

I think Newsweek hit it right on the head when they called the Natural Gas Policy Act a classic case of overregulation. That is what the problem is and to solve that problem we cannot take one segment of it or another segment of it and try to sell that to the public as the solution, because it will not work.

It may work for a month or maybe 2 months but then we will be back to all of the problems we had before, only they will be worse.

[The prepared statement of Senator Wallop follows:]

STATEMENT OF HON. MALCOLM WALLOP, A U.S. SENATOR FROM THE STATE OF WYOMING

I think that it would be wise at the outset of this hearing to place the natural gas issue into the broader context of America's energy future, a future which has become—like our nation's highways—a path of many potential potholes. We are living in an energy era that is and will be defined by numerous unpredictable variables. There exists the possibility of extreme fluctuations in fuel prices, real or contrived fuel supply shortages and we still face the nagging dependence on foreign oil imports.

Natural gas is part and parcel of America's energy future. Today it contributes 27 percent of America's energy, and heats over 40 million American homes. Moreover, unlike several years ago—when the Natural Gas Policy Act was enacted, natural gas is plentiful, and the assumption that we are rapidly running out of this clean burning fuel has been proven wrong.

Some had all hoped that the natural gas debate ended in the enactment of the Natural Gas Policy Act back in 1978, and that the problems of market and supply had been resolved. Nonetheless, peaking natural gas prices are sending shock-waves throughout the Country, seriously straining consumer pocket-books and forcing many industrial users to look for less expensive, alternative fuels.

Wyoming, like its sister states, has been hit hard this winter with unusually cold weather coupled with sky-rocketing gas prices. My constituents, particularly the poor and elderly, are badly strained to meet their monthly bills.

Therefore, I easily sympathize with others whose constituents are similarly suffering and understand the desire to remedy the situation as soon as possible. However, the bills recently proposed would only provide cosmetic relief and do not get to the heart of the problem.

The Natural Gas Policy Act which Newsweek called "a classic case of over regulation" is an extremely complex piece of legislation, and its ramifications have been no less complex. To address this issue properly and responsibly, we must make a comprehensive review of its impact on the market place. If we start tinkering with it here and there, thinking that we see the light at the end of the tunnel, I suggest that we may find that light attached to a speeding locomotive. That in turn may be yet another shortage of fuel created not by God but by government policies of regulation and construction.

It may sound corny, but what America needs today is a visionary government with the political courage to rise above the pressures of the many special interest groups. At a time when the country is caught up in swirls of unpredictability, courage in politics is our single most important asset in our quest for energy independence.

I hope that today's hearing will begin a dialogue on how natural gas can properly contribute to that goal of independence.

Senator **WARNER**. The Chair recognizes Senators in the order they are arriving; I believe the Senator from Montana is next.

STATEMENT OF HON. JOHN MELCHER, A U.S. SENATOR FROM THE STATE OF MONTANA

Senator **MELCHER**. Thank you, Mr. Chairman. I think there is a real emergency facing people today, whether it is their gas bills or whether they have enough heat and can't pay their bills having got the heat. The emergency has to be addressed. The proper way to address it immediately, and the only way to address it immediately for those who are hard put, is through fuel assistance.

That is not the best means by far, but it is the only means that will be available to Congress at this time. That emergency really must be met and it has little to do with the hearings we are having this morning, but it is a good point of departure to say that fuel assistance must be available for those who will not otherwise be able to pay their gas bills or their heating bills.

So perhaps the snowfall that we have had here in the Washington area over the weekend will remind every Member of Congress as we bog through this week on the continuing resolution for appropriations that fuel assistance funds indeed must be available and that is the true emergency that Congress faces right now on behalf of our constituents at home.

Thank you.

Senator **Warner**. The Senator from Louisiana.

STATEMENT OF HON. J. BENNETT JOHNSTON, A U.S. SENATOR FROM THE STATE OF LOUISIANA

Senator **Johnston**. Thank you, Mr. Chairman. I am very pleased that we are having these hearings. It has been very hard to get the Congress to focus on the question of natural gas. I have had legislation pending here for months and months. In fact, in February of this year I put in legislation because the Natural Gas Policy Act is bound to produce the kind of dislocation which the subject of this hearing. These dislocations can only get worse, indicating that the NGPA needs to be drastically amended.

However coming in at the 11th hour and attempting to freeze in the inequities you presently have in the Natural Gas Policy Act is simply not the way to do it. In the first place it will not work. The most recent DOE monthly energy review shows prices have gone up 95 cents in the last year. Of the 95 cents, only 10 to 17 cents is caused on account of increased wellhead prices under the NGPA, only 10 to 17 percent. The take-or-pay provisions of contracts account for only 11 to 15 cents of this increase.

Put differently only about 30 percent of the increase is attributable to the factors of take-or-pay provisions or increased NGPA prices. The rest of the increase is caused by such things as importation of Canadian and Mexican gas, the high price imported LNG, and from the reallocation of the pipeline tariff to a reduced number of consumers. These are the real factors behind the increase.

Unfortunately, we cannot harken back to that bygone day when we did not have to import LNG's and Canadian gas, and you cannot eliminate these factors by stopgap legislation. What we need to do is to focus attention on this problem today and tomorrow and then come back early in January with some real meaningful legislation that will get us out of the NGPA just as quickly as we can.

That is the only way we are going to solve this problem. That is the way that crude oil was put on a more settled and orderly basis and that is the way we should do it with natural gas.

Thank you.

[The prepared statement of Senator Johnston follows:]

STATEMENT OF HON. J. BENNETT JOHNSTON, A U.S. SENATOR FROM THE STATE OF LOUISIANA

This morning's hearings will discuss the current state of the natural gas marketplace and the various legislative proposals designed to remedy the problems inherent in the marketplace. I wish to thank the Chairman for his timely scheduling of this hearing. I also wish to applaud our colleagues who have joined us today for their recognition of the very real problems which now exist in the natural gas industry and for their initiative for seeking to remedy those problems.

We have recently begun to experience the anomaly of rising natural gas prices in the midst of relative surplus. With the prospects for an especially cold winter and its possible effect on the natural gas consumer, it is only right that we begin to focus our attention on the causes of this situation and possible solutions thereto.

The natural gas industry is a very complex combination of supply, transportation and distribution facilities. It is an industry which has long labored under one of the most complex and confusing regulatory systems ever imposed on any segment of our society. It is an industry which is currently suffering from severe market distortions and statutorily imposed inequities. The current series of market ordering problems which are being exhibited are but a portion of a much broader and more complex set of ills. It is my concern that the proposed solutions to the current situation, while well intentioned, may not adequately address the root of the problem, will not work in time to alleviate it, and indeed may increase the disorder already present in other segments of the industry.

If I may be permitted to generalize, these proposed solutions fall into three basic categories:

(1) A freezing of NGPA wellhead prices as of a date certain;

(2) An abrogation, either total or partial, of so-called "take-or-pay" contract provisions; and

(3) A requirement that a pipeline purchase only the least expensive supplies of gas available to it under contract.

I wish to review each of these in turn.

PRICE FREEZE

The proposed gas price freeze seeks to inhibit the escalation of consumer prices by freezing the phase-up of wellhead prices under the NGPA. I have several concerns with this proposal.

First, it strikes me as illogical to address an admittedly inequitable law by freezing it into place. Even more importantly, however, I fear that a price freeze impacts only slightly the problem it seeks to address.

According to the Department of Energy, average residential gas prices increased 95 cents mmbtu from July 1981 to July 1982, the latest month for which figures are available. Of this amount, DOE attributes only 39 cents to increased producer revenues. The remaining 56 cents is due to purchases of expensive Canadian gas and imported LNG, and from a decrease in gas demand which has resulted in the fixed tariff costs of the pipelines being applied to a smaller volume of gas. Neither the price freeze nor the other current proposals seek to address these factors which contribute to the cost increases.

Of the 39 cents due to increased producer revenues, only 25–44 percent, or about 10–17 cents, is attributable to increased wellhead prices, with the remainder due to a change in supply mix. Thus, a wellhead price freeze would have eliminated only 10–17 cents of the 95 cents increase in gas prices over the last year. When compared to the $5.61 mmbtu price of natural gas delivered to the consumer, this amount is even less significant.

A price freeze may, however, create additional problems within the natural gas market. For example, most freeze proposals call for a freezing of § 107 prices, which are currently decontrolled. Over the past 6–8 months the price for § 107 gas has been coming down, a trend which would undoubtedly be halted by a price freeze. Further, such a freeze could serve as a legal barrier to any pipeline which wishes to exercise a market-out provision in its contract. Finally, a freeze could serve to inhibit renegotiation of natural gas contracted by removing price as a subject of renegotiation. In light of the limited benefit that such a freeze would offer, these factors indicate that a freeze may well be counterproductive.

TAKE OR PAY

During the 1950's and 1960's, pipelines generally contracted for gas on what was known as a "1:4" or "1:5" basis. That is, the contract provided for a daily delivery of one million cubic feet of gas for each 4 or 5 billion cubic feet of reserves. Such a contract resulted in reserve additions of roughly 11–14 years respectively.

Several problems resulted from this approach. The first was the inexactitude of measuring reserves and the long range planning problems which resulted. The second, and more important problem, was that while such contracts may have provided for a long term supply, there was no ability to increase deliverability to meet short-term increases in demand such as could result from a cold winter.

The response of the industry was to change from reserve based contracts to deliverability based contractes. Pipelines began to contract for a percentage of the gas which a producer could deliver from a particular field. This was much easier to determine than reserve totals, and helped protect against unexpected surges in demand. It also became a popular feature of negotiation. With gas prices statutorily determined, it was possible to make a contract more attractive by increasing the percentage of deliverability. These factors accounted for contracts for 70, 80, 90 and even 100 percent of deliverability.

This approach posed no problem so long as demand generally equalled or exceeded supply. It did, however, leave pipelines extremely vulnerable to even short-term declines in demand. We are currently experiencing such a decline as a result of the recession.

Several of the legislative proposals before us today seek to address that problem by statutorily abrogating, or allowing a pipeline to abrogate, all or a portion of that percentage of gas deliverability which it is required to take. I am again concerned that the limited benefits from such an approach do not justify the potential harm it may cause.

Remember that only 39¢ of the 95¢ increase in last year's average gas prices was due to increased producer revenues. Remember also that 10–17¢ of that amount was due to increased wellhead prices. This leaves 22–29¢ attributable to a change in supply mix. Not all of this amount is due to take-or-pay provisions, however.

Each year a pipeline must replace about 10 percent of its gas reserve base. This results either from contracts which have expired or from reserves which have been depleted. Thus, only about 11–15¢ of the 95¢ increase in price is due to take-or-pay provisions. This, out of an average residential cost of $5.61.

Such a legislative provision, however, has potentially the most devastating effect on the marketplace. Many producers acquired loans based on the guaranteed income that take-or-pay provisions promised. To do away with these provisions could damage not only the financial integrity of the producers, but also that of the institutions to whom they are indebted.

I take little comfort from provisions in the legislation which seek to address this problem by allowing a producer to have his take-or-pay provision reinstated if he can demonstrate impending bankruptcy. There are literally thousands of producers who would be impacted, and each would have to prove his case in an evidentiary hearing before the Federal Energy Regulatory Commission. F.E.R.C. is an institution seldom noted for its expeditious response to requests for administrative relief, and in light of the number of producers who would seek such relief I believe we could expect chaos, delay and numerous bankruptcies to result.

Secondly, abrogation of take-or-pay requirements could have an equally adverse impact on intrastate pipelines. At least some of the proposals allow statutory relief only for interstate pipelines. This would serve to increase the competitive bidding advantage which interstate lines already hold over their intrastate counterparts.

Perhaps more importantly, however, doing away with take-or-pay requirements would reduce the deliverability surplus of interstate pipelines. This would reduce their incentive and their ability to make the off-system sales upon which the intrastate lines have depended in the past. Thus, an important source of supply could be denied to intrastate pipelines while an additional bidding advantage would be granted to their interstate competitors. The full implications of such a proposal must be fully assessed before it is implemented.

LEAST COST MIX

At least one proposal seeks to address the current problem by requiring pipelines to purchase the least expensive gas to which it has access under contract. Such a provision could again have disastrous effects on the producing segment of the industry.

Under the N.G.P.A. the Congress provided an incentive for producers to develop gas from areas where it was more difficult and expensive to drill. It did so through incentive pricing structures and through decontrol of gas produced from depths below 15,000 feet. A provision which required an absolute least cost mix could result in much of this expensive to drill gas being shut in. The economic effects on producers are obvious. So, too, are the effects of future exploratory drilling.

Further, such a provision again fails to address a very important cause of the current increase in prices. Contracts for expensive Canadian gas and imported LNG would not be effected. Indeed, pipelines might continue to import gas which is more expensive than domestic gas which has been shut in by operation of law.

The problems we are witnessing in today's natural gas market are very real and they are very frustrating. In such a situation it in only natural to look for a villain. It is all too easy to retrospectively criticize the business decisions of pipelines and producers who made rational and even predictable attempts to deal with a market distorted by 30 years of irrational and unpredictable governmental regulation. But I would assert that the problem lies less with the industry than with the law.

The problems we are witnessing today are but a mere hint of what is to come should the N.G.P.A. be allowed to run its course. I am the first to admit that the question of natural gas pricing should be addressed by the Congress. Indeed, I sought to do just that last February when I introduced a comprehensive set of proposals which sought to address the entire range of problems in natural gas policy. While current market conditions suggest that several of these proposals should be revised, the underlying premise remains valid—that is, we must deal with the very source of our problems, and we must do so in the context of an overall solution. This will not be an easy task, and it is one which should be conducted with the utmost of care and consideration. I would suggest that the waning days of the lame duck session are neither the time nor the place to undertake such an effort, and I would urge my colleagues to resist the temptation to do so. It is a responsibility which properly rests with the 98th Congress.

Senator **Warner**. Thank you very much. I should first call on Senator Domenici.

Senator **Domenici**. I have no opening statement.

Senator **Warner**. I think that concludes all of the Senators present.

[Statements submitted for the record from Senator McClure and Senator Murkowski follow:]

OPENING STATEMENT
CHAIRMAN JAMES A. McCLURE
COMMITTEE ON ENERGY AND NATURAL RESOURCES
MONDAY, DECEMBER 13, 1982

CURRENT CONDITIONS IN THE NATURAL GAS MARKET

GOOD MORNING. THE COMMITTEE WILL COME TO ORDER. THE CURRENT CONDITIONS IN THE NATURAL GAS MARKET HAVE PROMPTED THIS HEARING. THE COMMITTEE WILL EXAMINE THE NATURAL GAS PRICE INCREASES PROJECTED FOR THIS WINTER THROUGHOUT OUR COUNTRY, AND THE REASONS FOR THOSE INCREASES. BECAUSE OF SERIOUS AND LEGITIMATE CONCERNS, A NUMBER OF SENATORS HAVE INTRODUCED LEGISLATION INTENDED TO PROVIDE IMMEDIATE PRICE RELIEF FOR NATURAL GAS CONSUMERS.

WE ARE ALL EXTREMELY CONCERNED ABOUT THE SHARP INCREASES IN NATURAL GAS PRICES IN SUCH STATES AS KANSAS, IOWA, AND MISSOURI, BECAUSE WE KNOW THAT THE IMMEDIATE EFFECT OF THOSE INCREASES IS A SERIOUS FINANCIAL HARDSHIP TO MANY CITIZENS AND BUSINESSES IN THOSE STATES. BUT WE ALSO MUST BE CONCERNED ABOUT ANOTHER TYPE OF HARDSHIP THAT COULD CONFRONT THOSE SAME CITIZENS AND BUSINESSES TWO OR THREE YEARS FROM NOW IF A NEW SHORTAGE OF NATURAL GAS SHOULD OCCUR. IN THAT EVENT, THEY WOULD AGAIN BE FORCED TO CHOOSE BETWEEN CLOSING FACTORIES OR HEATING SCHOOLS AND HOMES, JUST AS THEY HAD TO MAKE SIMILAR CHOICES IN THE MID-1970'S.

DURING THE MID-1970'S, OUR COUNTRY WAS FACED WITH SERIOUS AND WIDESPREAD SHORTAGES OF NATURAL GAS. MANY OF THE MEMBERS OF THIS COMMITTEE WERE IN THE SENATE THEN AND WE REMEMBER VERY WELL TESTIMONY DESCRIBING THE HARDSHIPS CAUSED BY THE SEVERE SHORTAGES THAT OCCURED DURING THE WINTER MONTHS. WE ALSO RECALL THAT THE MIDWEST WAS ONE OF THE REGIONS OF THE COUNTRY THATSUFFERED MOST FROM THOSE SHORTAGES.

THE CONGRESS ATEMPTED TO PROVIDE A SHORT-TERM REMEDY BY ENACTMENT OF EMERGENCY NATURAL GAS LEGISLATION. SUBSEQUENTLY, IN ORDER TO INCREASE LONG-TERM SUPPLIES THROUGH A SYSTEM OF PRICE INCENTIVES, THE CONGRESS ENACTED THE NATURAL GAS POLICY ACT OF 1978. THE TASK OF REACHING A COMPROMISE ON CHANGES IN NATURAL GAS PRICING WAS AN EXTREMELY DIFFICULT TASK----IT TOOK 18 MONTHS. TODAY, THE CONGRESS IS AGAIN BEING ASKED TO LEGISLATE ON NATURAL GAS PRICING, BUT WE HAVE BEEN ASKED TO DO SO IN ONLY THREE WEEKS, DURING THIS POST-ELECTION SESSION. WITH ONLY A FEW DAYS LEFT, SOME OF US PERCEIVE THAT THERE MAY BE A TIME PROBLEM.

THERE IS NO REASON TO BELIEVE THAT THE CURRENT NATURAL GAS PRICING PROBLEM CAN BE RESOLVED IN A RELATIVELY SHORT PERIOD OF TIME. I SAY THAT FOR TWO REASONS: FIRST, THE STRUCTURE OF THE NATURAL GAS INDUSTRY ITSELF IS EXTREMELY COMPLICATED. EACH PART OF OUR COUNTRY IS SERVED BY A DIFFERENT COMBINATION OF INTERSTATE AND INTRASTATE PIPELINES AND DISTRIBUTION COMPANIES, EACH WITH ITS OWN UNIQUE SET OF GAS SUPPLY SOURCES, CONTRACTUAL OBLIGATIONS, AND MARKET REQUIREMENTS.

SECOND, THE NATURAL GAS INDUSTRY TODAY IS MORE COMPLEX AND DIVERSE THAN IT WAS WHEN WE ENACTED THE NGPA -- LARGELY BECAUSE OF THE NGPA. FOR EXAMPLE, SOME PRODUCERS ARE SELLING PRINCIPALLY OLD GAS AT LOW PRICES, WHILE OTHER PRODUCERS ARE SELLING PRIMARILY NEW GAS, OR DEEP GAS, AT MUCH HIGHER PRICES. AND THERE IS THE WHOLE RANGE IN BETWEEN.

THERE ARE PIPELINES FORTUNATE ENOUGH TO HAVE UNDER CONTRACT LARGE VOLUMES OF LOWER-PRICED OLD GAS, WHILE OTHER PIPELINES MUST RELY HEAVILY ON RESERVES OF NEW GAS, AND PAY THE HIGHER PRICES. AMONG DISTRIBUTION COMPANIES, THERE IS WIDE DIVERSITY REGARDING THE VULNERABILITY OF EACH COMPANY TO REDUCED DEMAND, SUCH AS THE LOSS OF INDUSTRIAL LOAD THROUGH FUEL SWITCHING.

ANY ACTION BY THE CONGRESS TO ASSIST NATURAL GAS CONSUMERS MUST ALSO DEAL WITH THE MANY COMPETING INTERESTS WITHIN EACH SEGMENT OF THE GAS INDUSTRY. COMPANIES WITHIN EACH SEGMENT WOULD BE AFFECTED DIFFERENTLY BY THE VARIOUS LEGISLATIVE PROPOSALS. TO IGNORE THE POTENTIAL EFFECTS OF LEGISLATION ON THESE COMPANIES IS TO INVITE SERIOUS FINANCIAL DISORDERS NOT ONLY WITHIN THE PRODUCING, TRANSPORTING, AND RETAILING SEGMENTS OF THE NATURAL GAS INDUSTRY BUT ALSO WITHIN OUR CAPITAL MARKETS.

BEFORE THE CONGRESS TAKES ANY LEGISLATIVE ACTION, WE MUST ALSO DETERMINE THE EXTENT TO WHICH MARKET FORCES ARE COMPELLING PRICE REDUCTIONS AT THE WELLHEAD, AND IN THE PIPELINE AND DISTRIBUTION PORTIONS OF THE INDUSTRY. I NOTE THAT THE GENERAL ACCOUNTING OFFICE IN ITS REPORT RELEASED LAST WEEK REFERRED TO THE "GROWING BODY OF EVIDENCE THAT THE NATURAL GAS MARKET IS ACTING TO REDUCE PRICES AND OTHERWISE ADJUST TO THE CURRENT 'EXEESS SUPPLY'." IF THAT IS THE CASE, IT MAY BE POSSIBLE TO REMOVE SOME OF THE EXISTING RESTRAINTS ON MARKET FORCES SO THAT THE CONSUMER CAN BENEFIT FROM THE LOWER PRICES THAT WOULD RESULT.

IN CONCLUSION, AS WE INITIATE THIS REVIEW OF CURRENT NATURAL GAS MARKET CONDITIONS AND PROPOSED LEGISLATIVE REMEDIES, I WISH TO EMPHASIZE AGAIN THAT ANY PROPOSALS TO REDUCE OR RESTRAIN NATURAL GAS PRICES PROJECTED FOR THIS WINTER MUST BE CAREFULLY BALANCED AGAINST THE RISK OF RETURNING TO SHORTAGE CONDITIONS AS WERE EXPERIENCED IN THE 1970's.

FOLLOWING ANY OPENING STATEMENTS BY OTHER MEMBERS OF THE COMMITTEE WE WILL PROCEED TO THE SENATORIAL WITNESSES.

STATEMENT OF
SENATOR FRANK H. MURKOWSKI
COMMITTEE ON ENERGY AND NATURAL RESOURCES
DECEMBER 13, 1982

The attention this hearing is receiving is in itself testimony to the fact that there is a great deal of anxiety over natural gas prices today. Higher energy costs appear to be in our future, and there is no way we can promise the American people otherwise. We can, however, take actions to allow the natural gas market to respond to market pressures in a way that it cannot respond today. The question before us, therefore, is: What should we do, and when should we act to relieve the long-term problem?

There is little disagreement over the fact that natural gas prices have not responded to market forces -- prices are climbing despite the fact there is a market surplus. In the middle of the heating season when we are most likely to hear from our constituents about high gas prices, the temptation to isolate a single, simple cause of this seemingly irrational price behavior is compelling. Many would have us believe that the so-called "take-or-pay" provisions or the indefinite price esculator clauses in gas purchase contracts are solely to blame. While the "contracts problem" is partially to blame for higher consumer costs, the ultimate cause of the market distortions we see today -- let this be no mistake -- is the Natural Gas Policy Act.

Perhaps I have the luxury of saying that because I was not a member of the Senate when the NGPA was enacted back in 1978. I've been told that I should be thankful for that fact. The NGPA emerged only after long, painstaking negotiations, and I realize at the time it represented a fragile consensus of a wide variety of different interests. As much as I appreciate the necessity of compromise in the American political system, the compromise embodied in the NGPA resulted in a far too complex 28-tier pricing system under which prices for natural gas can vary as much as 3500%. That complex pricing structure, the economic conditions and softened energy demand of the past two years, and the traditional nature of natural gas pricing contracts have all combined to push prices upward despite the fact there is a temporary market surplus.

In addition, we seem to overlook the fact that we are continuing to deplete low-cost gas reserves. The gas which will be rolled-in to replace the low-cost gas will cost a good deal more.

I have noted with great interest the introduction of a number of bills designed to address the gas pricing problem. My concern is that this legislation may be an attempt to make a short-term quick fix which may not even affect the gas prices paid by consumers this winter. I welcome their introduction and this hearing as a means to lay the groundwork for a rigorous and responsible effort to address the problem early next session.

I commend my colleagues who have expressed their concerns on behalf of their constituents about these dramatic price increases. I believe the gas production and distribution industry must do what they can to respond to whatever inequities may exist in the price structure. It is in the best interest of the gas industry to recognize the political realities of these price increases and apply its ingenuity to finding a solution in the renegotiation of contracts when possible -- the alternative might be a government-imposed "solution" which industry might find more onerous.

Senator **Warner**. We now turn to our three colleagues who are here to testify this morning. Might the Chair first inquire as to an equitable time allocation? What suggestions might you have?

Senator **Kassebaum**. We would like equal time with Senator Metzenbaum.

Senator **Warner**. Take as much time then as you feel is appropriate. This is very important to the committee and the Senate and many who have taken this initiative.

STATEMENT OF HON. ROGER W. JEPSEN, A U.S. SENATOR FROM THE STATE OF IOWA

Senator **Jepsen**. Thank you, Mr. Chairman, and thank you for what I know is a bipartisan problem and there is not anything more tragic than a home without heat or the heat it needs. This is a serious problem. It is unfortunate that it seems that we have exploitation of this problem for some political reasons and I do not think it has a place. We can quit pointing fingers; there is enough blame to go around. We need to get solutions. And that is what I would propose, Mr. Chairman.

Last September I introduced S. 2892 to amend the Natural Gas Policy Act to permit the natural forces of price, supply and demand to run their course in determining what Americans will pay for natural gas during the coming decade.

The temperatures may have cooled a bit since I introduced my bill in September, but consumer concern about the rapidly increasing cost of the fuel which warms more than half of the homes in this Nation, has heated up considerably.

It is easy to overlook the fact that the original objective of the Natural Gas Policy Act of 1978 was to achieve free market determination of natural gas prices.

The theory was that deregulation would unbridle the competitive forces within the natural gas industry, encourage more gas production and moderate future gas price increases.

At the heart of this issue, Mr. Chairman, is the long-term contracting between natural gas suppliers and pipeline companies. These contracts, many of which extend into the 21st century, have no provisions which allow price reductions in response to over supply or lower demand.

As usual, Mr. Chairman, even though it was well meaning at the time it was executed when Government attempts to stimulate the marketplace, the contract structure and pricing schemes constructed by the Natural Gas Policy Act cannot respond to changes in the economy.

And the Natural Gas Policy Act has come face to face with a very serious problem and that is the emergency economic recovery.

The chief intent of the long-term contract sanctioned by the NGPA was to increase production and to protect consumers against the anticipated inflationary spiral of natural gas prices, but with the death of inflation consumers have found themselves locked into long term contracts at artificially high prices.

The framers of the Natural Gas Policy Act assumed the very worst—high inflation, high consumption and low supply. The

American people in the natural gas industry have shown a special strength in defeating all of these.

These contracts have made supply and demand irrevocable in establishing future prices and as a result eliminated any possible benefits that consumers would have realized from natural gas deregulation.

By way of comparison, let me point out several advantages, Mr. Chairman, which I feel my bill offers over the other 39 pieces of natural gas pricing legislation.

The first area is the much debated pricing freeze. This concept causes me particular concern for several reasons. Pipelines have entered into agreements which have resulted in gas acquisition, often under take-or-pay contractual arrangements, which have resulted in rapidly escalating purchased gas costs. These are far in excess of wellhead price increases under NGPA.

The problem with a multitiered pricing program established by NGPA has been aggravated by certain contracting practices. The resulting market disorder will not be resolved by freezing prices, most of which, frankly, are at an all-time high.

As I said before, we need to allow market forces which are at work right now to bring prices to a level consistent with consumer demand. These forces will eventually stabilize gas prices, let the markets work and resolve many of the symptoms of market disorder that we suffer today. Freezing prices will only frustrate the markets ongoing efforts toward resolution.

Other proposed legislative bans, take-or-pay contracts, my bill addresses this too. Rather than banning take or pay in toto, I propose to limit it to 70 percent of daily volume by including this in an expanded definition of the existing fraud and abuse test. Take-or-pay contracts are not new. They perform a necessary role in keeping gas producers in business by providing them a somewhat predictable cash flow. Severe reduction could adversely affect producers and adversely affect future gas supply. This is not in the national interest or in the interest of consumers anywhere.

We must avoid the temptations to reregulate, to throw the industry back into Federal regulatory irons. As I see it, the challenge before us is to make natural gas deregulation work in the public interest by strengthening Federal oversight and review.

This is a much more difficult task, but worthy of our best efforts. And I thank you, Mr. Chairman.

Senator **Warner**. Thank you very much, Senator. What is your view with respect to the Senate/Congress proposal to address this problem during the lameduck session?

Senator **Jepsen**. Mr. Chairman, as evidenced by the fact that there have been about 40 bills introduced in recent weeks on the matter and that burner tip gas prices have escalated far in excess of the intent of the NGPA and done so quickly, largely in the past few months, I think an immediate remedy is called for.

It is incumbent on the Congress to fix this "made in Washington" problem before it adversely impacts consumers and businesses across the Nation in a major way. I think it is of utmost urgency that we move and move promptly.

Senator **Warner**. Senator Kassebaum.

STATEMENT OF HON. NANCY LANDON KASSEBAUM, A U.S. SENATOR FROM THE STATE OF KANSAS

Senator **Kassebaum**. Thank you, Senator Warner. I would like to join with my colleagues and say how pleased I am that this hearing has been called, because I do believe it is a very critical issue. I would agree with those who say it needs to be dealt with with care and with thought. It is extremely complex and it was not something that happened overnight.

I would agree with Senator Metzenbaum that it is something that we should have been looking at some time ago and as Senator Johnston pointed out he has had legislation in. It is also an easy issue to demagog. And I think that as we address this and try to understand the complexity of it and what can be done in the immediate future, it is incumbent upon all of us to put forward our best efforts.

I would like to congratulate Senator Jepsen who was the leader in this with legislation which he introduced in September, realizing that we do have, I think, a very critical problem. It is clear that the natural gas market today is a distorted, inefficient allocator of our energy resources. One simple fact is sufficient to establish the existence of this distorted market: The price is increasing for a commodity of which we have a surplus.

The natural gas industry has, of course, experienced one of the classic cases of market distortions caused by governmental regulation in the two decades preceding the enactment of the NGPA. I believe that Congress, although I was not here, had one overriding purpose in enacting the NGPA: To provide adequate supplies of natural gas at prices consumers could afford. Congress chose two principal weapons in its attempt to achieve this purpose, the elimination of the interstate/intrastate market disparities and the stimulation of production through the orderly increase of prices.

No one can argue with the fact that the NGPA has succeeded in creating adequate present supplies of natural gas. The 20-year decline of reserves-to-production ratios has balanced off and, in fact, the Energy Information Administration estimates that in 1981 reserve additions and revisions exceeded production by 1.8 percent.

Five major pipelines serving the midwest project surplus supplies this winter totaling over 379.8 Bcf. A recently released FERC study reports that no significant curtailments will occur this winter. Finally, and of the most important in my region of the country, conventional domestic gas production is being shut-in at an increasing rate.

Adequate supplies were only part of Congress intent in enacting the NGPA, however. The other half of the equation was achievement of a price that consumers; residential, commercial, and industrial, could afford. We have failed to achieve this second portion of the goal of the NGPA.

The delinquent account situation of many utilities is reaching alarming levels. This winter in Kansas alone, rates are projected to rise between 30 and 40 percent.

Nor are the effects of the price problem restricted to residential customers. And I think this is something that should concern us as we address this problem. The rapid price rise, exacerbated by the

Fuel Use Act, has led to a high level of fuel-switching away from natural gas by industrial customers.

In 1981, the gas utility industry lost an average of over 160 Bcf. of load, predominately to residual oil, when compared to 1980. In the first 5 months of 1982 this figure averaged 226 Bcf. Nearly every distribution company faces the same situation, that they have lost or are about to lose, valuable industrial customers. Such load loss adds to the residential problem as fixed utility costs are spread over a shrinking customer base. It also contributes to our dependence on imported oil.

High prices in and of themselves certainly do not indicate a distorted marketplace for natural gas. However, high prices, rapidly increasing, in a surplus market certainly indicate that a problem exists. It is necessary to break down the total wellhead price increase in order to get at the source of this artificial price inflation. From mid-1981 to mid-1982, the average wellhead price of natural gas rose approximately 17 percent. Some of this increase is attributable to the increasing ceiling prices for gas set in the NGPA.

According to a study by the Energy Information Administration, more than 75 percent of the increase, however, is due to increasing purchases of the high cost, section 107 gas. We need to look no further than the Hugoton field in Kansas to see these statistics brought to life. In the 5-year period beginning in 1977, five major pipelines drawing from the Hugoton field saw their total supplies from all fields grow by a modest 1.4 percent.

During that same timeframe, however, the five pipelines' total take of Hugoton gas actually declined by more than 26 percent. What made up this discrepancy? Most of it was made up by an increase this winter alone of over 42 Bcf. in the purchases of high cost Wyoming and Canadian gas. When you consider the fact that the average Hugoton sale this winter will average below 50 cents Mcf while the high priced gas ranges from $6 to $9 Mcf, the absurdity of the market becomes very evident.

What would lead rational businessmen to forsake our inexpensive conventional gas for exotic high-priced supplies? The main culprit, I believe, is the pervasive existence of take-or-pay obligations binding pipelines to producers. High take-or-pay percentages based on open-well deliverability have so restricted the natural gas market that it cannot respond in a rational manner.

Estimates of the portion of total supplies subject to take-or-pay obligations range as high as 80 percent. Quite clearly, these take-or-pay obligations lead to the abandonment of low-cost sources of gas first in a period of slackening demand.

I do not ascribe the existence of these take-or-pay provisions covering high-cost gas to any malevolent motives on the part of either pipelines or producers. In the scramble to sign up much needed supplies after the enactment of the NGPA, long-term contracts for steady supplies looked like a wise move at almost any price or take-or-pay percentage.

If this problem existed in a market in which the end consumers were free to pick and choose among competing products, I would clearly favor leaving it to the industry itself to work out. Such is clearly not the case in the natural gas market. Captive end users, coupled with the regulated nature of the pipelines and utilities which link those users to the producers, insure that the consequences of these take-or-pay contracts are borne almost entirely by those who had no part in incurring them and have no chance to escape them.

It is for this reason that I believe Congress has a responsibility to act to correct the distortions existing in the natural gas market today. For Congress to sit back at this time and do nothing while artificial forces in the market are inflicting great harm on natural gas consumers through the regulatory mechanism of the purchased gas adjustment would be to shirk our duty.

The legislation I have introduced seeks to deal with the take-or-pay situation by allowing pipelines to adopt a more balanced mix between low cost and high cost gas. The main tool to be used in achieving this goal is a specific grant of legislative authority to FERC to allow pipelines to modify their take-or-pay obligations in order to permit them to increase their usage of lower cost gas.

A prudence standard is added to the current grounds of fraud, abuse and misrepresentation contained in section 601 of the NGPA for denying purchased gas adjustments. These two features would work together to disallow the passthrough of purchased gas costs when it could be shown that a pipeline had imprudently failed to avail itself of the opportunity to modify its take-or-pay obligation.

It is important to realize that my legislation will not prevent the passthrough of costs without giving the pipelines the opportunity to modify their take-or-pay obligations. To do so for an extended period of time would clearly be unfair in that it would leave pipelines obligated to the producer, while denying them the mechanism to recover the costs in question.

A prudence standard does not mean a mandate requiring the purchase of only lower cost gas. Nor does it mean the elimination of all take-or-pay obligations. What it does mean is that pipelines should not be increasing their purchases of high cost gas at the expense of available lower cost supplies in the face of falling demand and increasing surpluses.

We should be as concerned about the fall in demand as we are about the higher prices. I fully realize the important function that take-or-pay obligations at reasonable levels serve. That is why I have not adopted the approach of some of my colleagues of abrogating all take-or-pay obligations. Our natural gas regulatory scheme has traditionally placed the primary responsibility for the long-term balancing of gas supply and demand on the interstate pipelines.

Modifications of take-or-pay obligations will return to these pipelines the flexibility necessary to achieve such a balance in the changing gas market of today. No matter what degree of freedom is granted pipelines in their contracting practices, the obligation to their customers to acquire a long-term supply of gas under reasonable and favorable terms remains.

To help insure thal pipelines have sufficient incentive to purchase lower cost gas, my legislation requires FERC to apply an incentive rate of return procedure in pipeline rate cases. The goal of such a device will be to encourage a pipeline to contract for the maximum amount of low cost gas which is consistent with that pipeline's long-term supply and demand posture and its physical characteristics.

I do not believe that a rigid, legislated incentive rate of return based on purchases above some mythical market clearing price would be desirable. In practice, such a price would be impossible to determine and individual pipeline considerations might well make its application inappropriate anyway.

But I think the incentive rate of return, a balance with the prudent standard, is a good combination.

The other portion of my bill, which is the more controversial portion, it is to freeze the wellhead price of natural gas at October 1 levels for a period of 2 years. This freeze would consist of three distinct facets. First, for the categories of gas which have a ceiling price set by the NGPA or currently specified by FERC, no escalation is allowed in that ceiling price beyond the level achieved on October 1.

Contracts for these categories of gas with prices below the lawful ceiling would be allowed to escalate at the lesser of inflation or the rate specified in the contract until reaching the October 1 ceiling level. Second, the wellhead price of gas which does not have a ceiling price may not rise above the level specified in the respective contracts as of October 1.

The freeze would also prohibit FERC from raising the incentive prices, or deregulating, those categories of gas over which they have or purport to have such authority. I refer specifically to tight sands and section 109 gas. Finally, all decontrol dates in the NGPA would be delayed by 2 years.

The freeze that I am proposing would not affect the price which could be paid for supplies of section 107 gas from a well the surface drilling of which began after October 1. Since any new purchases of such gas would be subject to my newly created prudence standard, the price and frequency of those purchases should be at a more rational level. Indeed, we have already seen a dramatic softening of the price which new supplies of 107 gas can command.

At the same time, I believe that it is important that pipelines be free to pay the price necessary to stimulate and secure 107 supplies if and when they are truly needed. The effect of this freeze would be to halt that portion of the rate increases which result from the phased decontrol and inflation escalation of the wellhead prices of natural gas. Even though, as I pointed out earlier, such escalation does not make up the bulk of the increases that we are experiencing, it is a significant portion.

It is important that we give some measure of certain relief to the consumer as soon as possible. This is vital, not just from the standpoint of easing the extreme financial burden facing consumers, but also in order to help regain the confidence of an extremely skeptical public.

I am happy to participate in the hearing this morning. I hope it will be a subject the Energy Committee will address with some urgency, even though as you point out, one should not race hastily into this. It is a subject which you all know very well; it is a subject which many of us have come to learn in far greater depth than we ever thought we would in the last several months and I feel it is, as a matter of fact, is a question that the lame duck session should address and could address without hurting the long range study and legislation, which I am sure the Energy Committee will be addressing in the next Congress.

Thank you very much.

Senator WARNER. Thank you.

Senator Boschwitz.

STATEMENT OF HON. RUDY BOSCHWITZ, A U.S. SENATOR FROM THE STATE OF MINNESOTA

Senator BOSCHWITZ. Thank you, Mr. Chairman. I want to not repeat some of the testimony that my colleagues have given and so I want to direct my testimony somewhat differently. I also want to be sure that at least my constituents understand that I don't address my remarks at local gas companies, local utilities, it is the great gas pipelines that transport it across the country.

In our neck of the woods Northern State Power or Mini-Gasco really are not involved in the discussion that I have with this committee today. Mr. Chairman, let me also comment in response to my friend from Ohio about the 1978 Natural Gas Policy Act. The Senator from Ohio laid a "heavy trip," as my son would say, upon this administration and I want to remind him that the Natural Gas Policy Act of 1978 was a product of the Carter administration, was heavily lobbied by them and the Secretary of Energy, Jim Schlessinger. Most Republicans, as I understand, voted against the bill and most Democrats voted for the bill, as I understand it.

I know that the Senator from Ohio led a very spirited filibuster against it, which caused even some changes in the Senate rules. But that is my understanding with respect to the bill which was a product of the Democratic administration, not the Republican administration.

Senator METZENBAUM. I don't want to interrupt my friend, but only two Republicans voted that way.

Senator BOSCHWITZ. That is fine in that case; I did not interrupt my friend from Ohio either.

Mr. Chairman, I respond to supply and demand. I have always done so in my business life and I see it happening in the natural gas market contravention of that response to supply and demand. I do not want to repeat the statements of Senators Jepsen and Kassebaum. I do indeed have a graph that I think all of you have that shows the increase of natural gas prices through 1981 and if you continue up to July 1982, the line continues to escalate at the same very rapid rate.

And while I understand that this is a short session, we must do something, certainly in our State of Minnesota, which is a cold State. People are going to be paying 20 percent more for gas on top of a 25-percent increase that they received last year. So if nothing else works, I would support the statement from the Senator from Montana that we should increase the funds in the emergency fund that would help people unable to pay their gas bills.

Mr. Chairman, I also have given you a table which shows the rate of return that the natural gas pipelines have in this country and I picked about a dozen of them and I picked those specific gas pipelines because they, almost their entire business, and in some instances their business, is involved with transporting gas across the country. And if you will note, for instance, I have left out Tennessee Gas, El Paso and others that are involved in many other things.

These companies are companies that are almost entirely involved or entirely involved in the transmission of gas. Notice their rate of return, Mr. Chairman. Their rates of return have been increasing almost without exception over the years and have been increasing since 1977 and have been increasing very markedly.

And then I say also to this committee that, frankly, these companies and many companies, my company, have made mistakes of business judgment in the past and one of them is the take-or-pay contract. Other mistakes I believe that they have made are some very rapid expansions in anticipation of an increased demand for gas that simply did not come about. But yet all of those things now go into the rate base and it is a troubling question to me of whether or not the consumer should be saddled with these mistakes.

In my business, you know, that just does not happen. The entrepreneur is saddled with those mistakes. I understand that a take-or-pay contract is just that, a contract, and that contract should not be breached, not only by legislation or otherwise. I find myself as a businessman often in a position of having contracts breached, a contract between myself and others.

I now have a building and they are going to put a roadway in front of that building. It is going to just do terrible things to the value of that building as well as to the business that takes place in it for a period of probably 2 years. I suppose I could go to court and spend legal fees that would approximate whatever I could recover and get some form of recovery, but contracts are often breached.

We change the rules around here not only on ourselves but on the people of the United States continually. My natural gas pipeline that serves my area came in and wanted an 18-percent return. An 18-percent return, Mr. Chairman, would double the net worth of the company in 4 years and then I suppose that pipeline would come in and want an 18-percent return on their heightened net worth. I think that we cannot participate in that.

And as a result I feel that that should also be a factor in the considerations of this committee, the heightening returns of these gas transmission companies and that these returns are predicated on investments that have not panned out and that the consumer should not now be caused to pay.

Furthermore, the consumer is conserving himself into higher gas prices. I think that that is unfair. As the Senator from Wyoming pointed out, there are some fixed costs, and the more gas you transport through the pipeline you make it up in volume, so to speak. It costs a little less to transport each cubic foot.

However, the consumer who is asked to conserve in the national interest should not now be called to pay higher prices because of that conservation. It is my hope that the introduction of Senator Jepsen's bill, Senator Kassebaum's bill, and 37 others—I did not realize there were so many—will cause the natural gas pipelines to go back and deal with some of their take-or-pay contractors, that they will buy their way out of these contracts, which I believe would be possible. I have bought my way out of a few myself, not that kind of a contract but others. And there must be a way out of this rather than abrogating them or allowing them to continue and raise, have a significant role in raising the gas prices.

I do not want to create the problems that Senator Wallop talked about. I believe that deregulation is preferable by in large to regulation. I am not an expert in this field. I do not claim to be, but I am concerned that consumers who have conserved their way to higher prices should be penalized through that conservation that they felt and that I felt was in the national interest.

I feel that consumers also should not be penalized for mistakes about expansion that were made in the energy industry or mistakes about contracts that were made in the energy industry and I feel that consideration should be given to moderating the rate of return to some of these natural gas pipelines.

All of industry has moderated its rate of return in the past few years and I think that it would not be unseemly or improper that during this period of time that the rate of return of these great pipelines should also be moderated.

Thank you, Mr. Chairman.

[The prepared statement of Senator Boschwitz follows:]

STATEMENT OF SENATOR RUDY BOSCHWITZ
HEARINGS ON NATURAL GAS
SENATE ENERGY COMMITTEE
DECEMBER 13, 1982

MR. CHAIRMAN, I WOULD LIKE TO FIRST THANK YOU AND YOUR COLLEAGUES ON THE SENATE ENERGY COMMITTEE FOR PROVIDING THIS OPPORTUNITY FOR ME TO TESTIFY ON THE NATURAL GAS ISSUE. THE COMMITTEE IS TO BE COMMENDED FOR HOLDING THIS HEARING IN RESPONSE TO THE GRAVE CONCERN THAT MANY SENATORS HAVE VOICED ABOUT THE EMERGING CRISIS IN THE NATURAL GAS MARKET.

I APPROACH THIS ISSUE AS ONE WHO HAS SPENT HIS WHOLE LIFE AS A BUSINESSMAN. IN MY CAREER I'VE COME TO UNDERSTAND THE LAWS OF SUPPLY AND DEMAND BETTER THAN I EVER DID BY READING ABOUT THEM IN AN ECONOMICS TEXTBOOK. WHAT TROUBLES ME AT THE MOMENT ABOUT NATURAL GAS IS THAT THE ECONOMIC LAWS I'VE LEARNED SO WELL ARE NOT WORKING IN THIS INDUSTRY.

AT PRESENT, DEMAND FOR NATURAL GAS IS DECREASING. ACCORDING TO THE DEPARTMENT OF ENERGY (DOE) CONSUMPTION OF NATURAL GAS IN THE UNITED STATES FOR THE FIRST NINE MONTHS OF 1982 WAS 5.7 PERCENT LOWER THAN DURING THE COMPARABLE PERIOD IN 1981.

MEANWHILE, NATURAL GAS PRICES HAVE BEEN SOARING. DOE FIGURES INDICATE THAT THE AVERAGE RESIDENTIAL HEATING PRICES IN THE U.S. HAVE GONE UP FROM $3.95 PER THOUSAND CUBIC FEET (MCF) in 1980 to $4.56/mcf in 1981. Prices have increased from $4.86/mcf in January 1982 to $5.59/mcf in July 1982.

Mr. Chairman, I have here a graph which shows the trend in average residential heating prices from 1973 to the present. I think this graph should remind all of us of the ever-increasing burden the consumer is being forced to bear.

What is truly tragic is that this burden is increasing. In my home state of Minnesota, where over 40 percent of total housing units are heated with natural gas, our energy agency informs me that natural gas prices are projected to rise nearly 20 percent in 1983. That would follow an increase of 25 percent from last year.

All this occurring when the consumer is doing his patriotic chore and conserving. As a businessman, I can't really understand that. I can assure you that prices I charge at my stores in the Midwest have not been rising during the current recession. Far from it!

What is the reason for this contradiction of the laws of supply and demand in the marketplace? Part of the explanation lies in the Natural Gas Policy Act (NGPA) of 1978. Under the NGPA prices of certain categories of gas are to be gradually decontrolled until 1985, when controls on them will be removed completely. This phased program of decontrol has achieved its purpose -- an elimination of the gas shortage

WHICH OCCURRED IN 1976-77. IT HAS PRODUCED A SURPLUS WHICH AMOUNTS TO ABOUT ONE TRILLION CUBIC FEET (TCF), ACCORDING TO THE FEDERAL ENERGY REGULATORY COMMISSION (FERC).

I'M CONVINCED, HOWEVER, THAT THERE IS MORE TO BE SAID ABOUT WHY CONSUMERS ARE BEING GOUGED WHILE THERE IS A GAS SURPLUS. I DON'T THINK THE MAJOR GAS PIPELINE COMPANIES ARE DOING ALL THEY CAN EITHER TO HOLD DOWN THEIR RATE INCREASES OR TO SEARCH FOR THE LOWEST COST GAS THEY CAN POSSIBLY FIND.

MR. CHAIRMAN, I HAVE RECENTLY HELD DISCUSSIONS WITH FERC REGARDING A PROPOSED $348 MILLION RATE INCREASE BY NORTHERN NATURAL GAS COMPANY, WHICH SUPPLIES OVER 90 PERCENT OF MINNESOTA'S GAS. THEIR PROPOSAL AMOUNTS TO A HUGE 22 PERCENT INCREASE OVER LAST YEAR, WHICH IS A GREAT PRICE TO ASK CONSUMERS IN MY STATE TO PAY. THIS BURDEN WILL FALL MOST HEAVILY ON THE NORTHERN PART OF MINNESOTA WHICH IS NOT ONLY THE COLDEST PART OF THE STATE BUT WHICH IS ALSO SUFFERING FROM OVER 20 PERCENT UNEMPLOYMENT. ACCORDING TO FERC, OTHER MAJOR GAS PIPELINES ARE GETTING ALONG ON AN 11-12 PERCENT RATE OF RETURN. I DON'T UNDERSTAND WHY NORTHERN CAN'T DO THE SAME.

I FIND CERTAIN ASPECTS OF NORTHERN'S RATE REQUEST RATHER PUZZLING. FOR ONE THING, NORTHERN ASKED FOR AN 18 PERCENT RATE OF RETURN THEIR INVESTMENT, WHICH I WOULD DEARLY LOVE TO EARN IN MY BUSINESS. HOW CAN SUCH A RATE OF RETURN POSSIBLY BE JUSTIFIED IN THE FACE OF ESCALATING GAS PRICES?

ANOTHER PART OF NORTHERN'S RATE INCREASE HAD TO DO WITH THE DECREASED VOLUME OF GAS BEING CARRIED IN THEIR PIPELINES DUE TO DEPRESSED DEMAND. SINCE THIS RAISES THEIR UNIT COSTS NORTHERN ASKS CONSUMERS TO PAY MORE IN GAS RATES, EVEN THOUGH THEY ARE CONSERVING. THAT STRIKES ME AS BLATANTLY UNFAIR. WHEN CONSUMERS START BUYING LESS FROM MY STORES I LOWER THE PRICE TO BRING THEM BACK. UNFORTUNATELY, THAT'S NOT HAPPENING IN THE NATURAL GAS INDUSTRY TODY.

WHAT IS MORE, I AM TOLD BY FERC THAT NORTHERN HAS OVERESTIMATED THEIR LOSS OF VOLUME, WHICH MEANS THEY HAVE ASKED FOR A LARGER RATE INCREASE THAN THEY SHOULD HAVE.

MR. CHAIRMAN, NORTHERN ALSO ASKED TO BE COMPENSATED BY FERC FOR THE PURCHASE OF HIGH-COST CANADIAN GAS WHICH THEY ORIGINALLY BEGAN TO BUY DURING THE SHORTAGE. BUT HERE AGAIN THE CONSUMER NOW WAS TO PAY THE COST OF THESE PURCHASES WHICH SIMPLY DON'T MAKE ANY SENSE DURING A PERIOD OF SURPLUS.

I HAVE RELATED THIS STORY ABOUT A GAS PIPELINE IN MY STATE TO MAKE THE POINT THAT CONSUMERS ALL OVER THE COUNTRY ARE AT THE MERCY OF PIPELINE COMPANIES WHICH IN SOME CASES DO NOT HAVE THEIR BEST INTERESTS AT HEART. I AM NOT TALKING ABOUT SMALLER RETAIL DISTRIBUTIONS OF GAS, SUCH AS MINNEGASCO AND NORTHERN STATES POWER IN MY HOME STATE. I AM TALKING ABOUT THE MAJOR PIPELINE COMPANIES LIKE NORTHERN NATURAL GAS.

FOR THIS REASON I HAVE IMPLORED FERC TO TAKE A HARD

LINE ON RATE INCREASES THIS WINTER. CONSUMERS DESPERATELY NEED A BREAK.

I HAVE ALSO JOINED MY COLLEAGUE SENATOR SPECTER IN INTRODUCING A BILL REGARDING SO-CALLED "TAKE OR PAY" CONTRACTS. I BELIEVE SENATOR DANFORTH HAS INTRODUCED LEGISLATION WHICH IS VERY SIMILAR.

MR. CHAIRMAN, BACK DURING THE GAS SHORTAGE PIPELINES ENTERED INTO TAKE OR PAY CONTRACTS WHICH HAVE NOW LOCKED THEM INTO PAYING FOR EXPENSIVE GAS WHETHER THEY USE IT OR NOT. THEY WERE EAGER TO GET GAS DURING THE SHORTAGE, TOO EAGER IN MY JUDGEMENT. NOW THE CONSUMER IS HAVING TO PAY FOR THIS EXPENSIVE GAS WHEN CHEAPER GAS IS AVAILABLE.

OUR BILL ON "TAKE OR PAY" CONTRACTS WILL ALLOW PIPELINES TO REFUSE TO TAKE GAS UNDER THESE CONTRACTS WITHOUT HAVING TO PAY FOR IT FOR A PERIOD LASTING FROM 15 DAYS AFTER THE BILL'S ENACTMENT TO NOVEMBER 1, 1983.

SECOND, IT ALLOWS FERC TO CHARGE A PIPELINE WHICH DOES NOT USE THIS RIGHT TO ACQUIRE THE LOWEST COST GAS AVAILABLE WITH "FRAUD AND ABUSE" UNDER THE STANDARD OF THE NGPA. FERC COULD THEN SCALE BACK A RATE INCREASED BASED ON A PIPELINE'S HIGHER COSTS FOR GAS PURCHASES.

MR. CHAIRMAN, I REALIZE NATURAL GAS PRICING IS A COMPLEX ISSUE AND THAT THERE IS PROBABLY MUCH MORE TO BE DONE TO RESTORE

SOME RATIONALITY TO THE NATURAL GAS MARKET. BUT I THINK THERE ARE AT LEAST TWO STEPS WHICH CAN AND MUST BE TAKEN IMMEDIATELY: A FIRM LINE ON NATURAL GAS RATE INCREASES BY REGULATORY BODIES AND SOME ACTION TO SOLVE THE PROBLEM OF "TAKE OR PAY" CONTRACTS.

THANK YOU, MR. CHAIRMAN. I AM HAPPY TO RESPOND TO ANY QUESTIONS.

TABLE I.

RATE OF RETURN ON STOCHOLDER'S EQUITY SELECTED MAJOR GAS PIPELINE COMPANIES 1977 - 1981 (In Percent)

	1977	1978	1979	1980	1981	Avg.
Columbia Gas System	11.4	12.2	13.0	13.9	14.2	12.9
Transcontinental Gas Pipeline Corp.	20.2	18.2	22.6	28.8	20.4	22.0
United Gas Co.	20.3	21.9	24.1	27.7	30.7	24.9
Natural Gas Pipeline	15.5	15.6	15.0	18.6	16.2	16.2
Michigan Wisconsin Pipeline Co.	16.0	17.8	17.3	14.4	15.8	16.3
Southern Natural Gas Co.	17.0	19.1	20.0	19.8	18.7	18.9
Consolidated Natural Gas Co.	13.2	12.4	13.1	11.4	13.8	12.8
Trunkline Gas Co.	19.6	17.1	20.4	18.6	19.9	19.1
Northwest Energy Co.	14.4	12.3	16.0	17.1	18.1	15.6
Pacific Gas Transmission Co.	11.5	11.3	12.0	9.9	21.8	13.3
Midwestern Gas Transmission Co.	7.5	12.6	14.5	19.3	14.8	13.7

Source: Merrill Lynch, Inc.

Avg. Total
16.9

The **Chairman** [Senator McClure presiding]. Thank you, Senator Boschwitz.

Senator Eagleton.

STATEMENT OF HON. THOMAS F. EAGLETON, A U.S. SENATOR FROM THE STATE OF MISSOURI

Senator **Eagleton**. Thank you, Mr. Chairman. I applaud the leadership of this committee for making this effort to begin to evaluate the present natural gas situation. I myself have never been completely comfortable with the idea of deregulating the natural gas market but I have acquiesced to the will of the majority in Congress, as was expressed in the Natural Gas Policy Act.

But times have changed during the last 5 years. What used to be a gas shortage is now a gas glut. And the prices that used to be low are now extraordinarily high.

One stark similarity between the situation that we faced in 1977-78 and the situation today stands out. In 1977 and 1978 we were faced with a natural gas emergency and today we are again faced with a natural gas emergency of equal magnitude.

I invite anyone who does not believe that we have a serious crisis on our hands to talk to some of the small gas producers who cannot sell their low-cost gas because the preverse gas market is forcing high-cost gas through the pipelines or better yet, I invite them to read some of the 2,000 letters that I received last week alone from Missourians outraged and horrified by natural gas prices.

The anxiety and the anger of gas consumers should come as no surprise to anyone who heats with fuel. The average bill has increased 92 percent in 4 years. Nationally, gas fuel bills are expected to jump on the average 20 to 25 percent this year, but many unlucky consumers will be socked by increases of over 60 percent.

Are these increases resulting in undue human suffering?

You bet they are. Kansas City, Mo. was hit by its first serious cold wave last weekend, this on the tail of a recent announcement that already 6,000 residents in that city have had their gas cut off due to inability to pay for the service. This figure represents a 2,000-home increase over the figure at the end of last winter.

For the committee's review, I would like to include with my testimony a table which outlines what kind of price hikes citizens in my State of Missouri can expect this winter. As the chart will show 5 of the 14 distribution companies project price hikes of over 40 percent and 1 company projects a 78-percent increase.

I would also like to submit a table showing on a State-by-State basis the increases in major pipeline charges to distribution companies during the NGPA and the numbers speak for themselves. The increases range from a low of 93 percent to a high of 286 percent. This during a time when inflation rose by 47 percent.

Now, the underlying cause of the increase is, of course, federally controlled gas price deregulation, but the frantic pace of recent price hikes is fueled by a host of other factors, including the so-called take-or-pay contract clauses.

Senator Danforth and I have introduced legislation that addresses two pressing needs, but even they are only short-term interim measures of limited scope. To help consumers who cannot pay their bills today, we have also introduced legislation to increase funding for low income energy assistance.

The first bill, and Senator Kassebaum has testified as to it, would declare take-or-pay clauses to be contrary to public policy and unenforceable. During the supply shortages of the 1970's, many natural gas pipeline companies entered into agreements with producers to accept delivery of very high priced gas which they have to pay for whether they need it or not.

When rising prices in a slumping economy diminished demand for natural gas, pipelines found themselves in a position of having to accept this high priced gas under their take-or-pay contracts, while shutting off available low-cost gas. And who pays the bill? The consumer and the producer who cannot sell his cheap gas.

Under our freeze bill, which is cosponsored by Senators Metzenbaum, Riegle, Sasser and Sarbanes, the maximum prices that producers will be able to demand from pipeline companies for most natural gas during the next 2 years will be frozen at the maximum levels existing under the Natural Gas Policy Act on August 31, 1982.

In the case of deregulated natural gas produced from a well drilled prior to December 2, 1982, the day we introduced the bill, the maximum lawful price will be the contract price for such gas on August 31, 1982. For any deregulated natural gas produced from wells drilled prior to December 2, 1982, but which was not covered by a contract on August 31, 1982, the maximum lawful price will be the average price on August 31, 1982, for deregulated natural gas produced from the three nearest wells covered by contracts on that date.

Our bill sets no maximum lawful price for deregulated natural gas produced from wells drilled after December 2, 1982. As each of you know there is an excess supply of natural gas today. If normal market forces work, contract prices for this new deregulated natural gas should not come close to the unreasonably high levels we have recently seen.

Pipelines now have no incentive to pay $7 or more for such gas when much cheaper gas is readily available. While I am not convinced that any categories of natural gas should be deregulated, I believe we can safely leave a relatively small amount of so-called high-cost gas deregulated while we fully evaluate the NGPA over the next 2 years.

I must emphasize at this point that our bill does nothing to impair existing contracts setting prices lower than those prices permitted by NGPA, nor does it prevent future contracts between producers and pipelines setting prices below the maximum levels set by the bill. I firmly believe that pipelines are under an obligation to bargain the best prices possible for natural gas.

As you know, the purpose of the bill is to provide some immediate relief to our Nation's gas consumers. The 98th Congress can then take the careful, thorough look at the NGPA, which I believe is urgently needed.

We know that the natural gas price hikes have devastated poor and middle income people and small businesses. We do not know, however, whether all this suffering has simply served to further bloat the corporate coffers of the Nation's natural gas producers. That is why our bill also directs the controller general to conduct a study of the profitability of natural gas production. The Controller General is to report to Congress by June 1, 1983. This report will provide this committee and the Congress with information essential to a thorough review of the gas market in the next Congress.

I am hopeful that we will be able to reexamine and revamp gas regulation mechanisms by the time the price freeze implemented in the bill would expire.

However, in light of previous congressional efforts to deal with comprehensive energy legislation, I am not confident this can be done. Therefore, for this reason our bill pushes the NGPA deadlines back for two years, until 1987. If Congress fails in its duty to rewrite the NGPA by the end of 1984, we simply cannot allow prices for more than half of our natural gas production to go through the roof. Extending the NGPA 2 more years gives us a backstop in the case that no positive congressional action would be taken.

I would suggest that a careful rethinking of the present gas situation is urgently needed. I have also stated that our bill and our initiatives to cap wellhead prices and conditionally abrogate take-or-pay contracts are just the first step toward and the catalyst for more comprehensive action to cure the sick gas market.

To that end, I look forward to this committee's serious consideration of natural gas legislation in the 98th Congress and I would like to suggest some specific issues which I think should be addressed.

First, are the NGPA prices cost justified or are they allowing producers to earn super competitive rates of return?

Second, why are residential consumers and small businesses being forced to pay $7 to $10 for MCF for natural gas, the equivalent of $60 per barrel of oil?

Third, are residential consumers and small businesses subsidizing low priority and less efficient users of natural gas?

Fourth, should we reserve natural gas for residential consumers and small businesses who, unlike most industrial users, cannot easily switch to alternative fuels, such as coal?

Fifth, has the NGPA increased supplies of natural gas? In fact, can natural gas supplies be substantially increased or is it a finite resource that should be reserved for high priority users?

Sixth, should pipelines be guaranteed that they can pass through to consumers any price increases to which they agree with producers?

Seventh, should pipelines direct sales to industrial consumers be regulated?

Eighth, does ownership of many pipeline companies of natural gas production reduce their incentive to bargain for the lowest prices for natural gas?

Ninth, are indefinite price escalators and most-favored-nation clauses in natural gas contracts unreasonable restraints of trade which should be outlawed?

Finally, has Congress granted too much discretion over gas prices to the Federal Energy Regulatory Commission? To date, as far as I can tell, FERC's policies seem to be based on a single proposition, namely, that natural gas prices should be as high as oil prices which are largely set by the OPEC cartel.

Every decision FERC has made under the NGPA has raised prices to consumers and given more money to producers. It has made no effort to direct low cost, low priced gas to high priority users, mainly residential consumers and small businesses.

The General Accounting Office recently completed a study that devoted one chapter to an examination of why gas prices have risen so rapidly. Mr. Chairman, I ask that the text of that GAO study be entered in the hearing record following my statement.

These and many other complicated natural gas market characteristics certainly deserve to be thoroughly analyzed by Congress. With a little luck and a lot of hard work, I hope that comprehensive legislation can be developed which will help clear up abuses and disorders in the gas market.

However, judging by the gas capades in 1977 and 1978, I am not confident that such legislation will be quickly agreed upon in both Houses. I understand the concerns of certain members of this committee that the gas problem not be handled under a panic type situation or a quick fix, but consumers want, need and deserve some kind of action now. They can and should have legislation that at least assures them that future gas hikes will be moderated and that their Congress will act quickly to come up with a long-term remedy.

I urge my colleagues to recall the winter of 1976 and 1977, when the gas market pendulum was at the other end of the swing. All agreed that the shortage of natural gas was an emergency situation that deserved immediate action. So in January of 1977, the Senate passed the Emergency Natural Gas Act.

It was a simple, temporary measure to enable the Government to cope with the prices that were then at hand in that winter. The Senate vote was nearly unanimous on the bill, 91 to 2. Senator Danforth and I offer our legislation in the same spirit as the Emergency Natural Gas Act of that winter. Our legislation is not submitted as a substitute to rethinking over all natural gas policy. It is an emergency holding action to aid consumers while Congress goes to work on a long-term solution.

The situation is grave this winter for thousands of gas-using Americans. We cannot wait until next spring or next summer or even next winter to get started on the crisis that is at hand today.

I urge the members of this committee to see the gas situation for what it is, that is a disaster that begs for our immediate attention.

The CHAIRMAN. Thank you very much, Senator. The table and GAO study will be made a part of this record.

Senator EAGLETON. Thank you, Mr. Chairman.

[The material referred to follows:]

MISSOURI DISTRIBUTION COMPANIES

DISTRIBUTOR	(a) # of Missouri residential customers	(b) % Change 1/82 - 1/83	(c) % Change 1977 - 1982
Associated Natural Gas Co.	40,273	41.6%	122.5%
Bowling Green Gas Co.	11,056	78.7%	186.6%
The Gas Service Co.	364,550	36.1%	272.4%
Great River Gas Co.	10,482	51.6%	157.2%
Laclede Gas Co.	514,561	23.5%	124.6%
Missouri Edison Co.	5,330	30.7%	85.0%
Missouri Power & Light	31,004	55.7%	104.1%
Missouri Public Service Co.	28,400	15.8%	145.2%
Missouri Utilities Co.	42,747	53.1%	
O'Fallon Gas Service Co. Inc.	2,440	27.0%	141.3%
Osage Natural Gas Co.	566	18.8%	85.9%
Peoples Natural Gas	1,400	14.9%	124.4%
Rich Hill-Hume	745	25.5%	134.5%
St. Joseph Light & Power	3,984	13.6%	126.8%
Total	(d) 1,057,538	(e) 31.32%	

(a) Number of customers based on most recent figures from individual distributors.

(b) Percent change from January of '82 to January of '83.

(c) Percent change of yearly averages 1977 to 1982.

(d) 91.13% of Missouri residential gas users.

(e) Mo. average weighted by total = 1,160,412 of customers.

STATE-BY-STATE INCREASES
IN MAJOR PIPELINE CHARGES TO
DISTRIBUTION COMPANIES UNDER THE NGPA

STATE	PIPELINE(S)	INCREASE FROM SEPT '78 TO SEPT '82 (CPI Increase 47.2%)*
Alabama	Southern Natural Gas Co.	115.1%
	Tennessee Gas Pipeline Co.	139.5%
	Texas Eastern Gas Pipeline Co.	232.4%
	Transcontinental Gas Pipe Line Corp.	138.8%
	United Gas Pipe Line Co.	169.4%
		159.0%
Arizona	El Paso Natural Gas Co.	163.1%
Arkansas	Mississippi River Transmission Co.	173.3%
	Tennessee Gas Pipeline Co.	139.5%
	Texas Eastern Transmission Corp.	232.4%
	Texas Gas Transmission Corp.	221.2%
		191.6%
California	El Paso Natural Gas Co.	163.1%
	Northwest Pipeline Corp.	121.4%
	Pacific Gas Transmission Co.	131.3%
	Transwestern Pipeline Co.	228.4%
		161.1%
Colorado	Colorado Interstate Gas Co.	192.8%
Connecticut	Algonquin Gas Transmission Co.	173.6%
	Tennessee Gas Pipeline Co.	139.5%
		156.6%
Florida	Florida Gas Transmission Co.	157.2%
	United Gas Pipeline Co.	169.4%
		163.3%
Georgia	Southern Natural Gas Co.	115.1%
	Transcontinental Gas Pipeline Corp.	138.8%
		127.0%
Idaho	Northwest Pipeline Corp.	121.4%
Illinois	Michigan Wisconsin Pipe Line Co.	127.4%
	Midwestern Gas Transmission Co.	164.7%
	Mississippi River Transmission Corp.	173.3%
	Natural Gas Pipeline Co.	93.8%
	Northern Natural Gas Co.	148.6%
	Panhandle Eastern Pipe Line Co.	178.4%
	Texas Eastern Transmission Corp.	232.4%
	Texas Gas Transmission Corp.	221.2%
	Trunkline Gas Co.	120.8%
		162.3%
Indiana	Michigan Wisconsin Pipe Line Co.	127.4%
	Midwestern Gas Transmission Co.	164.7%
	Natural Gas Pipeline Co.	93.8%
	Northern Natural Gas Co.	121.4%
	Panhandle Eastern Pipe Line Co.	178.4%
	Texas Eastern Transmission Corp.	232.4%
	Texas Gas Transmission Corp.	228.4%
	Trunkline Gas Co.	120.8%
		158.4%
Iowa	Michigan Wisconsin Pipe Line Co.	127.4%
	Natural Gas Pipeline Co.	93.8%
		110.6%

STATE	PIPELINE(S)	INCREASE FROM SEPT '78 TO SEPT '82 (CPI Increase 47.2%)*
Kansas	Cities Service Gas Co.	286.0%
	Colorado Interstate Gas Co.	192.8%
	Michigan Wisconsin Pipe Line Co.	127.4%
	Natural Gas Pipe Line Co.	93.8%
	Northern Natural Gas Co.	148.6%
	Panhandle Eastern Pipeline Co.	178.4%
		171.2%
Kentucky	Columbia Gas Transmission Corp.	168.4%
	Midwestern Gas Transmission Co.	164.7%
	Tennessee Gas Pipeline Co.	139.5%
	Texas Eastern Transmission Corp.	232.4%
	Texas Gas Transmission Corp.	221.2%
		185.2%
Louisiana	Southern Natural Gas Co.	115.1%
	Tennessee Gas Pipeline Co.	139.5%
	Texas Eastern Transmission Corp.	232.4%
	Texas Gas Transmission Corp.	221.2%
	United Gas Pipe Line Co.	169.4%
		175.5%
Maryland	Columbia Gas Transmission Corp.	168.4%
	Transcontinental Gas Pipe Line Corp.	138.8%
		153.6%
Massachusetts	Algonquin Gas Transmission Co.	173.6%
	Tennessee Gas Pipeline Co.	139.5%
	Transcontinental Gas Pipe Line Co.	138.8%
		150.6%
Michigan	Michigan Wisconsin Pipe Line Co.	127.4%
	Northern Natural Gas Co.	148.6%
	Panhandle Eastern Pipe Line Co.	178.4%
	Trunkline Gas Co.	120.8%
		143.8%
Minnesota	Midwestern Gas Transmission Co.	164.7%
	Northern Natural Gas Co.	148.6%
		156.7%
Mississippi	Southern Natural Gas Co.	115.1%
	Tennessee Gas Pipeline Co.	139.5%
	Texas Eastern Transmission Corp.	232.4%
	Texas Gas Transmission Corp.	221.2%
	Transcontinental Gas Pipe Line Corp.	138.8%
		169.4%
Missouri	Cities Service Gas Co.	286.0%
	Michigan Wisconsin Pipe Line Co.	127.4%
	Mississippi River Transmission Corp.	173.3%
	Natural Gas Pipeline Co.	93.8%
	Panhandle Eastern Pipe Line Co.	178.4%
		171.8%
Nebraska	Cities Service Gas Co.	286.0%
	Natural Gas Pipeline Co.	93.8%
	Northern Natural Gas Co.	148.6%
		176.1%
Nevada	El Paso Natural Gas Co.	163.1%
	Northwest Pipeline Corp.	121.4%
		142.3%
New Jersey	Algonquin Gas Transmission Co.	173.6%
	Consolidated Gas Supply Corp.	180.0%
	Tennessee Gas Pipeline Co.	139.5%
	Texas Eastern Transmission Corp.	232.4%
		181.4%

STATE	PIPELINE(S)	INCREASE FROM SEPT '78 TO SEPT '82 (CPI Increase 47.2%)*
New Mexico	El Paso Natural Gas Co.	163.1%
New York	Algonquin Gas Transmission Co.	173.6%
	Consolidated Gas Supply Corp.	180.0%
	National Fuel Gas Supply Corp.	196.0%
	Tennessee Gas Pipeline Co.	139.5%
	Texas Eastern Transmission Corp.	232.4%
		184.3%
North Carolina	Transcontinental Gas Pipe Line Corp.	138.8%
North Dakota	Midwestern Gas Transmission Co.	164.7%
Ohio	Columbia Gas Transmission Corp.	168.4%
	Consolidated Gas Supply Corp.	180.0%
	Michigan Wisconsin Pipe Line Co.	127.4%
	National Fuel Gas Supply Corp.	196.0%
	Panhandle Eastern Pipe Line Co.	178.4%
	Tennessee Gas Pipeline Co.	139.5%
	Texas Eastern Transmission Corp.	232.4%
	Texas Gas Transmission Corp.	221.2%
		180.4%
Oklahoma	Cities Service Gas Co.	286.0%
	Colorado Interstate Gas Co.	192.8%
	Natural Gas Pipeline Co.	93.8%
	Northern Natural Gas Co.	148.6%
		180.3%
Oregon	Northwest Pipeline Corp.	121.4%
Pennsylvania	Columbia Gas Transmission Corp.	168.4%
	Consolidated Gas Supply Corp.	180.0%
	National Fuel Gas Supply Corp.	196.0%
	Tennessee Gas Pipeline Co.	139.5%
	Texas Eastern Transmission Corp.	232.4%
	Transcontinental Gas Pipe Line Corp.	138.8%
		175.9%
Rhode Island	Algonquin Gas Transmission Co.	173.6%
	Tennessee Gas Pipeline Co.	139.5%
		156.6%
South Carolina	Southern Natural Gas Co.	115.1%
	Transcontinental Gas Pipe Line Corp.	138.8%
		127.0%
South Dakota	Northern Natural Gas Co.	148.6%
Tennessee	Michigan Wisconsin Pipe Line Co.	127.4%
	Southern Natural Gas Co.	115.1%
	Tennessee Gas Pipeline Co.	139.5%
	Texas Eastern Transmission Corp.	232.4%
	Texas Gas Transmission Corp.	221.2%
		167.1%
Texas	Cities Service Gas Co.	286.0%
	Colorado Interstate Gas Co.	192.8%
	El Paso Natural Gas Co.	163.1%
	Mississippi River Transmission Corp.	173.3%
	Natural Gas Pipeline Co.	93.8%
	Northern Natural Gas Co.	148.6%
	Tennessee Gas Pipeline Co.	139.5%
	Transcontinental Gas Pipe Line Corp.	138.8%
	United Gas Pipe Line Co.	169.4%
		167.3%
Utah	Northwest Pipeline Corp.	121.4%

STATE	PIPELINE(S)	INCREASE FROM SEPT '78 TO SEPT '82 (CPI Increase 47.2%)*
Virginia	Transcontinental Gas Pipe Line Corp.	138.8%
Washington	Northwest Pipeline Corp.	121.4%
West Virginia	Tennessee Gas Pipeline Co.	139.5%
Wisconsin	Michigan Wisconsin Pipe Line Co.	127.4%
	Midwestern Gas Transmission Co.	164.7%
	Northern Natural Gas Co.	148.6%
		146.9%
Wyoming	Colorado Interstate Gas Co.	192.8%
	Northwest Pipeline Corp.	121.4%
		157.1%

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* Many of these pipelines have made substantial rate increases since September, 1982.

UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

RESOURCES, COMMUNITY,
AND ECONOMIC DEVELOPMENT
DIVISION

December 9, 1982

B-210099

The Honorable Thomas F. Eagleton
United States Senate

The Honorable Michael D. Barnes
House of Representatives

The Honorable George Miller, et al.
House of Representatives

This report is in response to your separate, but similar, requests for information explaining recent natural gas price increases and simultaneous reports of "excess" natural gas supplies. This report is not an evaluation of any agency's performance and contains no recommendations.

This is a preliminary report, and we are continuing our efforts in this area. We did not obtain agency comments on the matters discussed.

We are sending copies of this report to the Secretary of Energy and the Chairman, Federal Energy Regulatory Commission.

J. Dexter Peach
Director

COSIGNERS OF REQUEST LETTER
FROM REPRESENTATIVE GEORGE MILLER

Representative Anthony Beilenson
Representative George E. Brown, Jr.
Representative Phillip Burton
Representative Ronald V. Dellums
Representative Mervyn Dymally
Representative Don Edwards
Representative Augustus Hawkins
Representative Edward J. Markey
Representative Matthew Martinez
Representative Robert T. Matsui
Representative Norman Mineta
Representative Toby Moffett
Representative John Seiberling
Representative Pete Stark

REPORT OF THE GENERAL
ACCOUNTING OFFICE

PRELIMINARY ANALYSIS OF
NATURAL GAS PRICE INCREASES

DIGEST

Reports that the price of natural gas will increase substantially this winter have received widespread attention. In response to congressional requests, GAO has prepared a preliminary analysis, which covers

--how fast prices have increased;

--why prices have increased; and

--whether there is an "excess supply," and if so, how it developed.

STRUCTURE AND REGULATION OF THE NATURAL GAS INDUSTRY

Natural gas--about 95 percent of it produced domestically--accounts for over 25 percent of the energy consumed in the United States. Industrial use accounts for 41 percent of all gas; residential, for 24 percent; electric generation, for 19 percent; commercial for 13 percent; and and other uses, for 3 percent.

The natural gas industry is comprised of three sectors--production, transmission, and distribution--which are physically interconnected by a network of pipeline and main throughout the United States. At one end of the network are thousands of companies which explore for, drill for, and produce gas. Since enactment of the Natural Gas Policy Act of 1978, all production has been subject to Federal price regulation. The act established various pricing categories based on such factors as where and when a well is drilled.

At the other end of the network are almost 1,600 distribution companies, usually local public utilities, serving their own market areas and under the jurisdiction of State or local regulatory bodies. The connecting transmission network includes 129 interstate pipeline companies operating under Federal jurisdiction, plus many intrastate pipelines which are generally regulated under State laws. (See pp. 1 to 3.

HOW MUCH HAVE GAS PRICES INCREASED?

Prices to all types of users increased at an annual average rate of 18 percent between 1970 and 1981 (not adjusted for inflation), according to data from the Energy Information Administration. Residential prices increased less (13 percent) than industrial prices (21 percent).

Nevertheless, residential prices today are higher than other prices. Residential users paid an average of $4.29 per thousand cubic feet in 1981; commercial users, $4.02; industrial users, $3.14; and electric utility users, $2.89. (See pp. 4 and 5.)

The average residential price in October 1982 was $6.08 per thousand cubic feet, compared to $2.83 in October 1978 and $0.91 in October 1970 (not adjusted for inflation), according to Bureau of Labor Statistics data for U.S. cities. The average price in selected major cities in October 1982 was as low as $4.94 and as high as $8.20. (See pp. 4 to 6.)

Prices paid by end-users flow back to the three industry segments as gross revenues. According to data from the American Gas Association, producers, pipelines, and distributors all received more revenue per thousand cubic feet in 1981 than in 1970. The producers' share of the total increased from 26 to 53 percent; the pipelines' share decreased from 29 to 25 percent; and the distributors' share decreased from 45 percent to 21 percent. (See pp. 6 and 8.)

The Energy Information Administration projects that the average residential price in the first quarter of 1983 will be about 20 percent higher than the year-earlier price. However, some cities are reportedly expecting increases of 40 percent or more. (See p. 8.)

WHY HAVE NATURAL GAS PRICES INCREASED?

End-user prices for natural gas depend on the diverse factors affecting how gas is priced to pipelines, to distributors, and to end-users. Prices paid by pipelines depend on both the quantity of domestic gas in each category under the Natural Gas Policy Act and the price of gas in each category, as well as imported gas. (See pp. 10 to 12.)

Several factors have affected the quantities and prices. One factor has been the regular increase in ceiling prices for various categories under the act. For example, the ceiling for new natural gas increased from $2.08 per million British thermal units (Btu's) in December 1978 to $3.27 in December 1982. (A million Btu's are approximately equal to a thousand cubic feet.) (See pp. 13 and 14.)

Another factor has been the creation of incentive prices for high-cost gas, as provided by the act. According to Energy Information Administration data for major pipelines' projected purchases, the average price of high-cost gas was $6.12 per million Btu's in mid-1981 and $7.24 in mid-1982. (See pp. 14 and 15.)

In addition, certain clauses in producer-pipeline contracts can cause average gas prices to increase. Many contracts obligate the pipeline to purchase a set amount of gas even if the pipeline does not have a ready market (called a "take-or-pay" clause). Such clauses were, in part, a reaction to the existence of Federal price ceilings in the interstate market, but not in the intrastate market, until 1978. (See pp. 16 to 20.)

Other factors include the depletion of old gas reservoirs and imported natural gas. (See pp. 15 and 22 to 23.)

Prices paid by distributors depend on the prices paid by the pipeline suppliers, plus pipeline operating expenses and rates of return. (See pp. 23 to 25.)

Prices paid by end-users depend on the prices paid by their distributors and the way these costs are allocated to residential, industrial, and other classes of users. For example, because of concern about industrial users switching to an alternative fuel, a California distributor has proposed a new rate schedule which would raise the average residential price by about 70 percent and the price to industrial users which can switch to residual fuel oil by about 31 percent. (See p. 25.)

IS THERE AN IMBALANCE BETWEEN GAS PRODUCTION AND CONSUMPTION?

Reports of a current "excess supply" of natural gas are consistent with major interstate pipeline estimates of supplies which will be available this winter. The duration of this imbalance is uncertain. (See pp. 26 and 27.)

This situation reflects the many factors which determine gas production and consumption. Pipelines eagerly sought new supplies during the 1970s when they could not provide as much gas as their customers desired. There is now an imbalance because pipelines are able to supply more gas than end-users want at current prices. (See pp. 26 to 30.)

Consumption has fallen due to more efficient use of gas, switching to alternative fuels, and economic conditions. Distribution company sales in the first 8 months of 1982 were 4 percent below year-earlier levels, according to the American Gas Association. (See p. 30.)

Some companies are adjusting to the current situation by renegotiating contracts and other means. (See pp. 30 to 32.)

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GAO initiated its analysis in response to requests from Senator Thomas F. Eagleton, Congressman Michael D. Barnes, and Congressman George Miller and 14 others.

As agreed with the requesters' offices, this is a preliminary report. GAO is continuing its analysis of natural gas price increases. GAO did not seek agency comments on this report.

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ABBREVIATIONS

Bcf	billion cubic feet
EIA	Energy Information Administration
FERC	Federal Energy Regulatory Commission
GAO	General Accounting Office
MmBtu	million British thermal units
Mcf	thousand cubic feet
NGPA	Natural Gas Policy Act of 1978
Tcf	trillion cubic feet

CHAPTER 1

INTRODUCTION

Reports of substantial increases in retail natural gas prices--both recent and expected--have attracted widespread congressional and public attention. These increases may seem particularly puzzling because of concurrent reports that there is a "glut" of natural gas, meaning that more gas could be produced and delivered than is being consumed. Ordinarily, such an imbalance between potential production and consumption would be expected to lead to declining, rather than increasing, prices to consumers.

Natural gas accounts for over 25 percent of the energy consumed in the United States. In 1981, natural gas use totaled 19.3 trillion cubic feet (Tcf), 1/ nearly all of it produced domestically. It is used in about 55 percent of all residential and commercial establishments and provides 40 percent of the energy consumed by industry and agriculture. Overall, industrial use accounts for 41 percent of all gas use; residential, for 24 percent; commercial, for 13 percent; electric generation, for 19 percent; and other uses, for 3 percent.

STRUCTURE AND REGULATION OF THE NATURAL GAS INDUSTRY

Most natural gas passes through three sectors of the industry before it is consumed. These sectors are regulated variously by units of Federal, State, and local government.

The industry is comprised of three sectors--production, transmission, and distribution--which are physically interconnected by a network of over 1 million miles of pipeline and main throughout the United States. At one end of the network are thousands of large, medium, and small companies which explore for, drill for, and produce gas. Approximately two-thirds of their gas production is sold in interstate commerce and has been subject to Federal price regulation since 1954, now administered by the Federal Energy Regulatory Commission (FERC). 2/ The remaining production is sold in intrastate commerce and has been subject

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1/Quantities of natural gas are often measured on the basis of volume. Frequently used measures include thousand cubic feet (Mcf), billion cubic feet (Bcf), and trillion cubic feet (Tcf). Alternatively, gas may be measured on the basis of heat content, in terms of British thermal units (Btu's). A million Btu's are approximately equivalent to an Mcf.

2/Successor to the Federal Power Commission. Established by the Department of Energy Organization Act of 1977, 42 U.S.C. 7107.

to Federal price regulation only since the enactment of the Natural Gas Policy Act of 1978 (15 U.S.C. 3301) (NGPA). 1/

At the other end of the network are almost 1,600 distribution companies, usually local public utilities, serving their own market areas and under the jurisdiction of State or local regulatory bodies. The connecting transmission network includes 129 interstate pipeline companies operating under the jurisdiction of FERC, plus many intrastate pipelines which are generally regulated under State laws.

Producers explore for new reserves of natural gas, develop them to determine their size, and extract the gas from the reserves. Having determined that a reserve is large enough to warrant marketing, the producer will usually negotiate to sell the gas to a pipeline company. Pipeline companies generally purchase this gas--under negotiated contracts--from producers in the field, transport it to market, and sell it either to distribution companies or directly to large industrial and electric utility end-users. 2/

Distributors purchase gas from pipeline companies and resell it to residential, commercial, or industrial customers. Prices paid by a distributor to a pipeline (known as wholesale or "city-gate" prices) depend on (1) field prices which are negotiated by the pipelines within regulatory limits and passed through to the customer and (2) delivery charges for transportation of the gas from the wellhead to the distributor. 3/ Distributors then deliver gas to the final consumer and charge a mark-up over their wholesale purchase price for their delivery services. 4/

Different end-users may pay a distribution company various prices for natural gas, depending on the type of end-use (for example, residential, commercial, industrial, or electric utility)

1/Production may also be subject to regulation at the State level, with respect to prices and levels of production.

2/Pipeline companies may produce some gas themselves and purchase gas from and resell to other pipelines. Some pipelines also transportation gas for customers which have their own gas supply.

3/Mark-up prices for interstate pipelines are generally determined by the historical average cost of transmission and by the transportation profit margins allowed under FERC regulation.

4/Neither pipelines nor distributors make a profit on the purchase and resale of gas. Mark-ups for both pipelines and distributors include operating and maintenance expenses, depreciation, interest, taxes, and net income. Thus, pipelines' and distributors' profits derive only from their investment in the transportation and delivery systems and not in the gas itself.

and on the type of service (for example, firm or interruptible supply).

In addition to the physical links between the three sectors of the natural gas industry, companies within these sectors can also be connected through common corporate structures. For example, some companies engage in production, transmission, and distribution activities and many of the largest interstate natural gas pipeline companies are involved in natural gas production either directly or through corporate affiliates. Some distribution companies are also involved in the gas producing business, while others are integrated with pipeline companies.

OBJECTIVES, SCOPE, AND METHODOLOGY

This report was prepared in response to separate, but similar, requests from Senator Thomas F. Eagleton, Congressman Michael D. Barnes, and Congressman George Miller and 14 cosigners. As agreed with the requesters' offices, we concentrated on three questions:

--How much have natural gas prices increased in recent years?
--What factors account for these price increases?
--Is there an excess supply of natural gas and, if so, why?

In this report, we present information in answer to these questions. With respect to the factors which account for price increases, we identified a number of such factors which could contribute, in some measure, to increases in various localities, but we did not attempt to determine which factors are most important in any specific locality. We are continuing our review of natural gas price increases.

In preparing this report, due to time constraints, we relied largely on available data and reports by FERC, the Energy Information Administration, the Bureau of Labor Statistics, and the American Gas Association. We did not independently verify the accuracy of any of these data. Some of the price data on which we relied are adjusted for inflation; others are not adjusted. In each case we identify whether the data were adjusted.

We also relied on our report on "Pipeline Purchases of High-Cost Natural Gas: Extent and Contested Issues" (EMD-82-53, Apr. 6, 1982) and on information gathered in connection with current natural gas reviews. We also discussed the matters covered in this report with representatives of production, pipeline, and distribution companies; Federal and State-regulatory agencies; and consumer advocates. Information gained from these sources is cited below in many instances.

Additional details on our methods are included in the subsequent chapters.

This report was prepared in accordance with generally accepted government audit standards.

CHAPTER 2

HOW MUCH HAVE PRICES INCREASED?

Although the magnitude of recent and expected price increases has attracted widespread attention, natural gas prices have been rising for many years. At the time of the landmark Supreme Court decision in Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954)--which formed the basis for Federal regulation of producer prices--the average wellhead price was $.10 per Mcf. In contrast, the price in 1981 was $2.06. 1/

This chapter treats price increases since 1970 from three perspectives: (1) nationwide average prices charged to various classes of end-users, (2) prices charged to residential customers in selected cities, and (3) the breakdown of end-user prices by sector of the natural gas industry.

PRICES PAID BY CLASSES OF END-USERS

First, we compiled Department of Energy data on prices paid by various classes of end-users between 1970 and 1981. There were differences in 1981 prices to various end-user classes and in the rates of increase between 1970 and 1981. (See table 1.)

Residential and commercial users paid the highest average prices in 1981--$4.29 and $4.02 an Mcf, respectively. Electric utility and industrial users paid the lowest average prices--$2.89 and $3.14 an Mcf, respectively.

Rates of increase also varied. Compounded annual average rates (not adjusted for inflation) increased 11 percent a year between 1970 and 1973 and 22 percent a year between 1974 and 1981. However, in each of the 4-year periods for which we computed average annual increases, residential prices increased by the smallest proportion, followed by commercial prices. Industrial and electric utility prices increased by larger proportions in each 4-year period.

RESIDENTIAL RATES PAID IN SELECTED CITIES

Next, we compiled Bureau of Labor Statistics data on residential prices between 1970 and 1982 for the Nation and for ten cities. These cities represent various regions of the country but do not necessarily reflect the full range of residential prices. (See table 2.) Furthermore, the data shown reflect average prices per Mcf of gas, not the quantity of gas used nor average customer bills.

1/Energy Information Administration, 1981 Annual Report to the Congress, Volume 2: Energy Statistics, DOE/EIA-0173(81)/2, May 1982, table 51.

Table 1

Prices Paid by End-User Classes, Selected Years, 1970-81, and Rates of Increase

Year	Residential	Commercial	Industrial	Electric utility	Overall average
	Average Price				
	(price per Mcf)				
1970	$1.09	$0.77	$0.37	$0.29	$0.55
1974	1.43	1.07	0.67	0.51	0.84
1978	2.56	2.23	1.70	1.48	1.85
1981	4.29	4.02	3.14	2.89	3.39
Period	Compounded Annual Average Rates of Increase				
	(percent)				
1970-74	7	9	16	15	11
1974-78	16	20	26	31	22
1978-81	19	22	23	25	22
1970-81	13	16	21	23	18

Source: Energy Information Administration, 1981 Annual Report Report to Congress, Volume 2: Energy Statistics, May 1982 DOE/EIA-0173(81)/2, p. 117, and Natural Gas Annual, 1981, DOE/EIA-0131(81), Sept. 1982, table 16.

These data reveal three trends. First, average prices for cities and prices for the ten cities all increased considerably over this period. Average national prices (not adjusted for inflation) increased by more than six-fold between 1970 and 1982. Prices for all but one of the cities increased between five-fold and seven-fold; San Francisco's prices increased almost nine-fold. Thus, the rates of increase were roughly comparable during the period.

Secondly, there were substantial differences between the lowest and highest prices. In 1970, the prices for San Francisco ($0.71 per Mcf), Atlanta ($0.84), Dallas ($0.86), and Cleveland ($0.87) were considerably lower than the prices for Boston ($1.53), Philadelphia ($1.43), and Seattle ($1.18). In 1982 the prices for Chicago ($4.94), Cleveland ($5.11), and Atlanta ($5.29) continued to be much less than for Boston ($8.20), Philadelphia ($7.54), and Seattle ($6.99).

However, there was some shifting in the cities' relative ranking between 1970 and 1982. For example, San Francisco and Dallas had the lowest prices in 1970 but some of the higher prices in 1982. Boston and Philadelphia had the highest prices in both 1970 and 1982.

The absolute difference between the lowest and highest prices increased from $0.82 per Mcf in 1970 to $3.26 per Mcf in 1982. The lowest price was 46 percent of the highest rate rate in 1970 and 60 percent in 1982.

COMPONENTS OF END-USER PRICES BY INDUSTRY SECTOR

Finally, we compiled data from the American Gas Association on the components of end-user prices by industry sector for 1970 and 1980. (See table 3.) Prices paid by end-users flow back to the three industry sectors as gross revenues. The data show that revenues to each sector--producers, pipelines, and distributors--increased between 1970 and 1981 (not adjusted for inflation). However, revenues to producers increased by the largest proportion and increased the producers' share of total revenues from 26 percent in 1970 to 53 percent in 1981. Conversely, revenues to pipelines and distributors increased at a slower rate, leading to a decline in the pipelines' share from 29 to 25 percent and a decline in the distributors' share from 45 to 21 percent.

Table 2

Residential Prices in Selected Cities, Selected Years, 1970-1982

	Price per Mcf in October of Year (note d)			
Location	1970	1974	1978 (note c)	1982
U.S. average	$0.91	$1.28	$2.83	$6.08
Atlanta	0.84	1.24	2.71	5.29
Boston	1.53	2.23	3.32	8.20
Chicago	1.00	1.31	2.78	4.94
Cleveland	0.87	1.21	2.18	5.11
Dallas	0.86	0.92	2.50	6.23
Los Angeles	(a)	(a)	b/ 1.85	5.71
Philadelphia	1.43	1.88	3.88	7.54
St. Louis	0.95	1.35	2.34	6.15
San Francisco	0.71	1.12	2.14	6.26
Seattle	1.18	1.62	3.74	6.99

Source: Bureau of Labor Statistics, Retail Prices and Indexes of Fuels and Electricity, Nov. 1970, table 6; Nov. 1974, table 7; and June 1978, table 7; and Energy and Food--October 1982, Nov. 22, 1982, table 1; and unpublished data.

a/Not available.

b/Earliest available data for Los Angeles are for November 1978.

c/Consumer prices were not collected from July through October 1978, due to revision of the BLS Consumer Price Index. Data shown were interpolated from June and November 1978 figures.

d/Based on prices for 100 therms of gas in each city, converted to cubic feet at a rate of 1,021 Btu's per cubic foot.

Table 3

Components of End-User Prices, by Sector, for 1970 and 1981

Sector	1970 Price per Mcf	1970 Percent of total	1981 Price per Mcf	1981 Percent of total
Producer	$0.17	26	$2.00	53
Pipeline	0.19	29	0.94	25
Distributor	0.29	45	0.80	21
Total	$0.65	100	$3.74	100

Source: American Gas Association, Gas Facts, 1980, p. 122, and unpublished data.

EXPECTED PRICE INCREASES TO RESIDENTIAL USERS

Expected price increases in cities around the country have received widespread media coverage. Such estimates are usually based on pipeline filings at FERC and on other factors; actual increases may ultimately be different.

The Energy Information Administration projects that the average price for residential users will be $5.97 per Mcf in the first quarter of 1983, about 20 percent higher than the year-earlier price of $4.99. 1/ Projected increases in individual cities, however, are expected to vary considerably. Distribution company representatives told us that some cities are expecting increases of 40 percent or more.

CONCLUSIONS

Prices paid by natural gas end-users vary considerably. Residential and commercial users (both over $4.00 per Mcf) paid higher prices than industrial ($3.14) and electric utility ($2.89) users in 1981. However, industrial and electric utility prices increased faster between 1970 and 1981.

1/Energy Information Administration, Short-Term Energy Outlook, DOE/EIA-0202 (82/30), Aug. 1982, p. 4. This estimate represents the middle of three cases projected by EIA, based on different assumptions of future world oil prices. Prices are shown in current dollars.

Prices paid by residential customers increased overall between 1970 and 1982, but at somewhat different rates. Current prices vary considerably from city to city--from less than $5.00 per Mcf to more than $8.00.

Natural gas producers' proportion of revenues from end-user sales increased from 1970 to 1981 (from 26 percent to 53 percent). The pipelines' share declined (from 29 percent to 25 percent), and the distributors' share declined (from 45 percent to 21 percent).

The Energy Information Administration projects that average residential rates will increase 20 percent from the first quarter of 1982 to the first quarter of 1983. Increases in individual cities will reportedly vary considerably.

CHAPTER 3

WHY HAVE PRICES INCREASED?

Although natural gas end-user price increases are not a new phenomenon, the reported magnitude of expected increases in some cities is unusual. This chapter examines various reasons which could account for some portion of the increases. It addresses the factors which affect: (a) prices charged to pipelines, (b) prices charged to distributors, and (c) prices charged to end-users.

In this preliminary analysis, we did not attempt to determine the contribution of each factor nor to determine which factors are most important in various localities.

PRICES CHARGED TO PIPELINES

Pipeline purchases from producers are governed by the Natural Gas Policy Act of 1978. The act established eight major price categories, covered by Sections 102 through 109, 1/ and additional sub-categories depending on when a well is drilled, how deep the well is, when and where the gas was contracted for, and other criteria. Allowable prices for these categories vary widely. This section discusses factors which affect prices charged to pipelines, including prices and quantities of domestic purchases from producers and of purchases of imported gas.

1/The NGPA's definitions of the major price categories are complicated. The following definitions are general descriptions only. Section 102 covers gas from new onshore reservoirs, new wells at a minimum distance or depth from an existing well, and certain Outer Continental Shelf reservoirs. Section 103 covers gas from new wells less than a minimum distance or depth from an existing well. Section 104 covers gas from wells dedicated to interstate commerce as of the date of enactment of NGPA. Section 105 covers gas under existing intrastate contracts as of the date of enactment. Section 106 covers gas under "rollover contracts," both inter- and intrastate; such a contract is entered into on or after the date of enactment for gas that was subject to an earlier contract that expired at the end of a fixed term. Section 107 covers high-cost natural gas, from wells at a depth of 15,000 or more feet and three other sources specified in the act or from other sources determined by FERC to present extraordinary costs or risks. Section 108 covers gas from "stripper" wells producing less than 60 Mcf per day under normal conditions or more than 60 Mcf per day due to enhanced recovery techniques. Section 109 covers gas not covered by any other price provision.

Domestic Purchases

Pipelines purchase gas from various NGPA categories and at various prices. The pipelines' average cost of gas in a time period depends on both prices and quantities. Both the quantity of gas in each category and the average price paid vary, as shown in table 4 for major pipelines' projected purchases for 2 successive years. (These data were compiled by the Energy Information Administration from pipeline filings at FERC, based on pipelines' projections of gas purchases in future periods.)

The total quantity increased by 2 percent. But the quantity of old (sections 104 and 106) gas contracted for in 1972 or earlier declined 15 percent, while the quantity of section 102 gas increased 18 percent and the quantity of high-cost (section 107) gas increased 70 percent.

The average price increased 17 percent (adjusted for inflation). The average price of old gas contracted for in 1973 and later declined 1 percent, old gas contracted for in 1972 or earlier increased 2 percent, and high-cost gas increased 18 percent.

The increase in the average price, from $2.01 to $2.35 (adjusted for inflation), reflects both changes in proportionate quantities and changes in prices. To provide some perspective on the relative importance of prices and proportions, we compared the actual prices and quantities for 1981 with two alternatives. First, we calculated the average price of buying the 1981 volumes at the 1982 prices, to illustrate the importance of changes in price; the average price went from $2.01 to $2.10. Secondly, we calculated the average price of buying the 1982 volumes at the 1981 prices, to illustrate the importance of changes in proportions; the average price went from $2.01 to $2.22.

The overall increase of $0.34 per Mcf may be compared with the 1981 quantities/1982 prices increase of $0.09 and the 1982 quantities/1981 prices increase of $0.21. The changes in proportionate quantities appear to account for about twice as much of the overall change as the price changes. Even after the 7-percent inflation rate between the two periods is considered, the changes in proportionate quantities appear to account for at least half the overall change. (These results relate only to the two periods cited above and would not necessarily hold true for other periods.)

The overall changes in quantities and prices reflect many factors, including increases in maximum lawful prices under the Natural Gas Policy Act, the establishment of incentive prices under section 107, the natural decline of gas reservoirs, recategorization of gas from one sub-category to another, the operation of certain clauses in producer-pipeline contracts, and the effectiveness of Federal regulation.

Table 4

Projected Natural Gas Wellhead Purchase Volumes and Prices For Major Interstate Pipeline Companies, 1981 and 1982

	Mid-1981 (note a)		Mid-1982 (note a)	
Category of gas	Volume in Bcf (note b)	Price per Mcf (note c)	Volume in Bcf (note b)	Price per Mcf (note c)
Old gas (note d) (Sections 104 and 106)				
Contract date 1972 or earlier	3,665	$0.89	3,129	$0.91
Contract date 1973 or later	2,683	1.75	2,674	1.71
New gas				
Section 102	1,992	3.04	2,342	3.20
Section 103	1,060	2.79	1,184	2.86
Sections 108 and 109	296	3.04	300	3.21
High-cost gas (Section 107)	390	6.12	664	7.24
Other	85	2.60	60	2.87
Total (note e)	10,170	$2.01	10,352	$2.35

a/For definition of periods covered, see source report.

b/Volumes are given at an annual rate.

c/Prices are given in constant January 1982 dollars.

d/Contract date was unknown for 226 Bcf in 1981 and 139 Bcf in 1982. To facilitate comparisons, these quantities were added--on a pro rata basis--to the quantities whose contract date was known. Prices for gas with a known contract date only were used.

e/Detail may not add to total due to rounding.

Source: EIA, An Analysis of Post-NGPA Interstate Pipeline Wellhead Purchases, DOE/EIA-0357, Sept. 1982, p. vi.

Increased ceiling prices

The Natural Gas Policy Act of 1978 provided for regular increases in the maximum lawful price for most gas. In many categories the increase was tied to the rate of inflation. But for section 102 (new natural gas) it was allowed to increase at an annual rate of 3.5 percent faster than inflation through April 20, 1981, and at an annual rate of 4.0 percent faster than inflation through December 31, 1984; on that date section 102 and certain other gas will be freed of Federal price controls.

Based on these factors, ceiling prices increased between December 1978 and December 1982 by 38 percent for most categories and by 58 percent for section 102. (See table 5.) These ceiling

Table 5

Maximum Lawful Prices for Selected Categories of Natural Gas, December 1978 and 1982

Section	Category of gas	Maximum lawful price per million Btu's December 1978	 December 1982
102	New natural gas, certain Outer Continental Shelf gas	$2.08	$ 3.27
103	New onshore production wells	1.97	2.71
104 and 106(a)	Existing interstate and intrastate contracts		
	Post-1974 gas	1.63	2.24
	1973-74 biennium gas (large producers)	1.06	1.45
	Interstate rollover gas	0.60	0.83
	Minimum rate gas (note a)	0.20	0.28
107(c)(5)	Gas produced from tight formations	(b)	5.42
108	Stripper gas	2.22	3.51

a/Price expressed in terms of Mcf.

b/FERC, by Order 99, Aug. 15, 1980, set the maximum lawful price for gas produced from tight formations at the lesser of the negotiated contract price or 200 percent of the Section 103 maximum price. The maximum price generally applies on or after July 16, 1979.

Source: FERC.

price increases promptly result in increased prices to pipelines, in many cases, because many producer-pipeline contracts obligate the purchaser to pay the "highest regulated rate."

Incentive prices for high-cost gas

Among the major pricing categories established by the 1978 act is section 107, High-Cost Gas. The act defined high-cost gas to include

--gas produced from a well deeper than 15,000 feet (if drilling began on/or after Feb. 19, 1977);

--gas produced from geopressured brine, released naturally from coal seams, and produced from Devonian shale; and

--other gas "produced under such other conditions as the Commission determines to present extraordinary risks or costs."

The act provides that the price for deep gas be limited to the section 102 ceiling price ($3.27 per MmBtu in Dec. 1982), and authorized the Commission to prescribe higher prices for any high-cost gas "to the extent that such special price is necessary to provide reasonable incentives for the production of such high-cost natural gas."

The Commission issued a regulation in November 1979, pursuant to the NGPA, which removed Federal price ceilings for deep gas and gas from the other three sources cited in the act. It issued another regulation in August 1980 which established an incentive price for gas produced from tight formations (geological structures which allow gas to seep out slowly, under normal conditions). It set a maximum price for such gas at twice the ceiling price for section 103 gas (equal to 2 x $2.71 = $5.42 in December 1982). 1/

According to EIA's analysis of pipelines' projected purchases by volume, high-cost gas constituted 4 percent in mid-1981 and 6 percent in mid-1982. For five pipelines, however, high-cost gas constituted 10 to 15 percent of all projected purchases. Pipelines expected to pay an average of $6.12 per MmBtu for all high-cost gas in mid-1981 and $7.24 in mid-1982 (both in January 1982 dollars). These prices are considerably higher than the average prices for all wellhead purchases ($2.01 in mid-1981 and $2.35 in

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1/See 44 Fed. Reg. 61,950 (1979) and 44 Fed. Reg. 56,034 (1980).

mid-1982). 1/ Therefore, high-cost gas constitutes a relatively large proportion of total gas costs for some pipelines.

In an earlier study, we found that high cost gas constituted from none to 40 percent of all projected wellhead purchase costs for 20 pipelines. This gas accounted for 5 percent or less for six companies, 6 to 25 percent for eight companies, and 26 percent or more for six companies. 2/

Depletion of old fields

A reservoir contains a given quantity of natural gas. The amount of gas that can be produced economically from a reservoir generally declines each year. The productive life of a reservoir varies, depending on geology and other factors: an individual well may produce economically for a few years or for 20 years or more. Thus, to maintain a stable gas supply, the continuing depletion of existing reservoirs is balanced by the addition of new reservoirs.

This turnover can lead to higher prices because production from the older reservoirs generally commands a lower price than production from the newer reservoirs. As previously noted in table 4 (page 12), expected prices in mid-1982 were $0.91 per Mcf for gas contracted for in 1972 or earlier, $1.71 for gas contracted for between 1973 and 1977, $3.20 for new gas (section 102), and $7.24 for high-cost gas.

Recategorization of gas

Because of the numerous pricing categories under the Natural Gas Policy Act, and the differences in maximum lawful prices, a producer has an incentive to try to get each well qualified to receive the highest possible price. The act--in section 101(b)(5)--provides that gas qualifying for more than one price category may be priced according to the highest applicable price category.

Moreover, the act and FERC regulations provide that gas produced from a well may qualify for an increased price under specified circumstances. For example, application of production enhancement techniques to a well may permit a producer to charge a higher price than would otherwise be permitted. As of August 1, 1982, according to FERC data, FERC had been notified that enhanced recovery techniques has been applied to 432 wells, thus

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1/Energy Information Administration, An Analysis of Post-NGPA Interstate Pipeline Wellhead Purchases, DOE/EIA-0357, Sept. 1982, pp. 6 and 28.

2/"Pipeline Purchases of High-Cost Natural Gas: Extent and Contested Issues," EMD-82-53, Apr. 6, 1982, pp. 10 and 11.

permitting gas from these wells to receive a higher price than they would otherwise qualify for.

There have been conflicting reports about the extent to which gas has been recategorized from a lower to a higher price. This phenomenon has been called "category creep." Based on these reports, it is not clear to what extent recategorization has increased prices.

A June 1981 study of wellhead price increases concluded that an "unexpectedly high" price for gas contracted for before enactment of NGPA appeared to be due, in part, "to a change in the mix of gas within the price subcategories * * *. The lower priced ones disappear more quickly than the higher priced ones, and, in fact, there may be some shifting of volumes into the higher priced groups" (emphasis added.) 1/

In its November 1982 report, EIA stated: "To the extent that such an effect can be estimated, the data examined and presented in this report provide no evidence that there has been any substantial degree of gas reclassification in the period studied." 2/ However, it should be noted that EIA's definition of "category creep" is more limited than that used elsewhere. EIA notes that it has been "hypothesized that some natural gas producers have been able to reclassify old gas volumes as new gas by drilling new development wells in old fields--often referred to as 'category creep.'" This definition does not include recategorization of flowing gas.

Clauses in producer-pipeline contracts

Contracts for the purchase of gas at the wellhead define the long-term relationship between the producers of gas and the purchasers--primarily pipeline companies--and in large part determine the cost of gas to distributors and end-users. The producer-pipeline contract specifies the terms and conditions of the gas sale. Among other things, the contract generally stipulates (1) the duration of the purchase agreement; (2) the price, including initial rate and price escalation provisions, the treatment of taxes, royalty payments, and deregulation clauses, if any; (3) the delivery rate--daily, monthly, and annual purchase (or "take") obligations and any makeup provisions; (4) the quantity of gas or acreage committed; (5) the gathering, processing, and delivery of the gas; and (6) the quality and measurement of the gas.

1/Edmond R. DuPont & Associates, Preliminary Assessment of Gas Rate Changes under NGPA, June 26, 1981, pp. 7 and 9. This study was prepared under contract for the American Gas Association.

2/EIA, An Analysis of Post-NGPA Interstate Pipeline Wellhead Purchases, DOE/EIA-0357, Sept. 1982, p. x.

Contracts reflect the relative bargaining leverage of producers and pipeline companies at a given time. This bargaining relationship has shifted over the years to adjust to changes in the overall supply and demand for gas both nationally and in specific regional markets, the regulatory environment, and internal producer and pipeline corporate policies. Because pipelines may have more than one contract with a producer, a specific producer-pipeline contractual relationship can be viewed in the context of a web of existing and prospective contracts.

Natural gas contracts--like other contracts--represent a compromise between the conflicting bargaining positions of the seller (the producer) and the buyer (the pipeline). The producer has certain objectives in negotiating a contract, as does the pipeline company. The producer tries to obtain, among other things, the highest possible contract price and large daily pipeline gas purchase obligations (a high contract price provides little revenue if the pipeline purchases only a small daily volume). In contrast, the pipeline desires large gas reserves under long-term contracts at a lower price and minimum daily purchase obligations. This allows the pipeline to provide its customers a secure, stable supply of gas.

Contracting practices appear to respond to changes in the overall market for gas. For example, in the early years of the industry when gas supplies were abundant, the demand for gas was limited because there was not yet a well developed pipeline system to bring the gas from the field to urban markets. As a result, contracts generally reflected the strong bargaining position of the pipeline. They were often long-term contracts, with low prices and low daily purchase obligations.

However, in later years, especially in the early 1970s, with the increased demand for gas and a limited supply of new reserves, the relative bargaining strength shifted to producers. Producers were able to incorporate into their contracts higher purchase obligations, prices at maximum allowed levels, and more frequent price redeterminations. More recently the pendulum has swung again, and pipelines have now been able to incorporate lower purchase obligations, provisions allowing purchasers to lower contract prices, and more favorable price escalation terms into contracts.

Other factors that affect the bargaining relationship are (1) the number of pipelines competing for gas in a specific producing area, (2) the size of the reserves, and (3) differing corporate perceptions of the future gas market and regulatory environment.

The universe of contracts is quite large. An estimated 20,000 mostly pre-NGPA interstate contracts are on file at FERC. 1/ Although most producers are no longer required to file contracts, FERC's Chairman estimated a year ago that between 9,000 and 10,000 contracts had been executed since the enactment of NGPA, covering new gas sales. 2/ At any time, a pipeline may have hundreds or thousands of contracts with gas producers. Further complicating this situation is the fact that a pipeline will often have several different gas contracts with an individual producer.

As noted above, many contracts obligate the pipeline to pay the "highest regulated rate." Two other types of clauses which have received considerable attention recently are "take-or-pay" clauses and "market-out" clauses. The former require the purchaser to pay the producer an amount based on a stated proportion of a well's potential or actual output--even if the purchaser chooses not to accept the entire quantity; however, such clauses often allow the purchaser to accept the paid-for gas in subsequent years. The latter allow the purchaser to offer the producer a lower price, if the existing price has made the gas unmarketable; however, such clauses often allow the producer to try to find another purchaser.

During the early and mid-1970s interstate pipelines could not always supply as much gas as their customers wanted. As will be explained more fully in the following chapter, they were subject to Federal price ceilings, which kept their prices lower than the levels which could be paid by intrastate pipelines. One way of redressing this imbalance was for the interstate pipelines to bargain on the basis of "non-price" contract terms, for example, take-or-pay clauses. 3/

"Take" obligations became increasingly strict during the 1970's. In some cases the purchasers were obligated to pay for 80

1/In general, small producer contracts, intrastate contracts, and contracts for onshore gas executed after the enactment of the NGPA are not on file at FERC. Some post-NGPA contracts for new offshore gas are on file at FERC. See Decision Analysis Corporation, Analysis of Natural Gas Producer/Interstate Pipeline Contracts, July 1, 1981, p. 2.

2/Based on well determinations filed with FERC since Dec. 1, 1978. This estimate appears in a Nov. 20, 1981, letter to Philip R. Sharp, Chairman, Subcommittee on Fossil and Synthetic Fuels, House Committee on Energy and Commerce, from C.M. Butler III, Chairman, Federal Energy Regulatory Commission.

3/"Non-price" is technically a misnomer. Such clauses do not relate to current prices, but they do relate to future prices, current and future quantities, and other conditions.

or 90 percent of the output of a well. Only in the last couple of years have "take" obligations become less strict or tempered by the presence of "market-out" clauses. 1/ However, the high "take" obligations in contracts signed throughout the last decade or more remain in effect unless renegotiated.

The effects of high "take" obligations have received considerable attention. Examples of the operation of such clauses have been noted in two regions.

--In the Hugoton field (in southwest Kansas, Oklahoma, and Texas), several pipelines have reduced their purchases of gas--much of which sells for as little as $0.50 per Mcf and are instead purchasing domestic and imported gas at $5.00 or more per Mcf, according to Kansas State and pipeline company representatives.

--In Appalachia, Columbia Pipeline has stopped accepting gas from 21,000 small wells, whose prices are as low as $0.45 per Mcf, while continuing to buy gas from southwestern producers for up to $8.30 per Mcf, according to a company official. He stated that the wells were "shut-in" for between 90 and 150 days and that the company also shut-in its own wells in Appalachia during the period.

There are several possible reasons why pipelines--when they expect to need less gas than they could purchase under existing contracts--may choose to forego relatively inexpensive gas and, instead, purchase relatively expensive gas. First, as a general rule, the more expensive gas is likely to be covered by contracts with higher "take" obligations. This occurs because take-or-pay clauses became more prevalent during the last decade or so, at the same time that maximum lawful prices were being increased.

Second, pipelines may prefer to buy gas from their own affiliated producers or production subsidiaries, rather than from unaffiliated producers. This could cause pipelines to buy relatively expensive gas because pipeline involvement in gas production has increased in recent years, at the same time that maximum lawful prices were being increased. Third, pipelines may be willing to pay higher prices to develop or retain the good will of producers on whom they may depend in various producing regions.

1/Energy Information Administration, Natural Gas Pipeline/Producer Contracts: A Preliminary Analysis, Dec. 1981, DOE/EIA-0312, and Natural Gas Producer/Pipeline Contracts and Their Potential Impacts on the Natural Gas Market: An Analysis of the Natural Gas Policy Act and Several Alternatives, Part 2, June 1982, DOE/EIA-0300.

Finally, pipelines' purchases may be influenced by the nature of Federal regulation. Pipeline tariff rates are established at least every 3 years based on a cost-of-service review. One aspect of such a review is a determination of the cost of gas purchased by the pipeline for resale. Recognizing that purchased gas costs would likely change more frequently than every 3 years, pipelines were allowed, starting in 1972, to adjust their rates in the intervening period. A pipeline's request to change its base tariff rates to reflect purchased gas costs is known as a purchased gas adjustment filing. Most interstate pipelines file an application every 6 months, while the remainder file annually. These filings are subject to FERC review and approval.

In the situation where a pipeline is contractually obligated to pay for more gas than it needs, if the pipeline pays for and receives gas from a producer, it can generally recover its costs through a purchased-gas adjustment filing every 6 months according to FERC officials. However, if a pipeline pays for but does not receive the gas, it cannot promptly recover such "pre-payments". Only after it receives the gas can it recover these "pre-payments" through a purchased-gas adjustment filing.

In the meantime, the pipeline can add the "pre-payments" to a specified account in its rate base and earn a rate of return on them. Therefore, to maintain cash flow, a pipeline may prefer to buy more expensive gas and recover its costs semi-annually, but incur any "pre-payments" on less expensive gas and recover these costs later. To the extent that "take-or-pay" and other contract clauses influence a pipeline to buy more expensive gas and forego less expensive gas, such clauses will contribute to an increase in the pipeline's average gas costs.

Federal regulation

Violation of Federal or State laws relating to prices received by producers or prices paid by pipelines could also result in price increases. NGPA specifies maximum lawful prices to be received by producers. It also specifies certain standards to govern pipeline purchases, including purchases from entities affiliated with a pipeline. FERC is responsible for compliance and enforcement with both types of regulation. If there were violations of either type of regulation, end-user prices would presumably be increased.

According to FERC data, it was found that too high a price had been charged at about 1,300 wells as of October 31, 1982, and about $39 million had been refunded since NGPA's enactment. (This amount may be compared to total producer revenues in 1981 of about $42 billion--20.4 Tcf of marketed production x $2.06 per Mcf average wellhead price.)

In addition, FERC regulates prices paid by pipelines. Section 601(b) of NGPA generally provides that producer-pipeline wellhead transactions are considered to be just and reasonable if the price does not exceed the maximum price authorized by Title I or if there is no ceiling for that category. Under section 601(c) interstate pipelines may pass through costs of natural gas purchases if the price, deemed "just and reasonable" under section 601(b), is not excessive due to "fraud, abuse, or similar grounds.' The meaning of this "fraud standard" is highly controversial and affects pipelines' authority to pass through hundreds of millions or even billions of dollars.

As we reported in April 1982, six pipeline company purchased-gas adjustment filings were protested in 1981 because of issues relating to the purchase of deregulated gas. 1/ Protesters contended, in part, that (1) prices paid for deregulated gas were too high in relation to prices for competing fuels; (2) prices paid to pipeline affiliates were too high; and (3) pipelines bought more deregulated gas than they needed.

The pipeline companies involved in the six cases responded, in part, that (1) the deregulated gas was purchased to obtain adequate reserves for their customers; (2) the protesters did not show that the purchases were unwarranted; and (3) the protesters were attempting to reimpose price ceilings on deregulated gas.

In February 1982, FERC issued a policy statement on its interpretation of the NGPA's provisions relating to pipeline pass-through of purchase gas costs as guidance for the disposition of proceedings where the fraud standard is an issue. 2/ The Commission stated that the general policy statement does not have the force of law, but "is an articulation of the Commission's tentative intention which will be followed unless circumstances demonstrate the policy to be inappropriate."

FERC said that it intended to limit the fraud standard to consideration of whether the price paid by an interstate pipeline was excessive due to misrepresentation, including a positive statement of fact or an omission of a material fact. It stated that the fraud standard is not a market-ordering device and that there is nothing within the 1978 act nor its legislative history enabling it to disallow pass-through of prices due to imprudence. FERC concluded that the fraud standard does not include imprudent business judgment about how much a pipeline should pay for gas. More recently, however, FERC indicated that it may consider questions of prudence of pipeline purchases. 3/

1/"Pipeline Purchases of High-Cost Natural Gas: Extent and Contested Issues," EMD-82-53, Apr. 6, 1982.

2/47 Fed. Reg. 6,253 (1982).

3/In connection with a purchased-gas adjustment filing of Tennessee Gas Pipeline (TA82-2-9), the Commission stated that it may consider questions of prudence as part of a pipeline's cost-of-service review.

Other Factors

FERC has been criticized for its part in several decisions which have allowed gas price increases to pipelines. 1/

--In March 1979 FERC reversed its month-earlier proposal and allowed the 1978 act to trigger "area rate clauses." These clauses may allow producers to charge as much as other producers in an area. (44 Fed. Reg. 16,895 (1979).)

--In July 1980, FERC permitted producers to obtain a higher wellhead price retroactive to December 1, 1978, based on a change in measuring the heat content of gas. (45 Fed. Reg. 49,077 (1980).)

--In August 1980, FERC decided to allow pipelines to collect NGPA rates for gas produced by pipeline affiliates. (45 Fed. Reg. 53,091 (1980).)

Imported Gas Purchases

Natural gas has been imported, primarily from Canada, for many years. In the last few years, imports have constituted about 5 percent of total national supplies, but much higher proportions for some pipelines and distributors.

Quantities of imported gas--from Algeria, Canada, and Mexico--changed little between 1978 and 1981. (See table 6.) However, prices increased significantly between 1978 and 1981.

1/A critical assessment of FERC's role in these and other actions is contained in "Comments of the Citizen/Labor Energy Coalition Regarding Notice of Inquiry," Docket No. RM82-26-000, Impact of the NGPA on Current and Projected Natural Gas Markets, Aug. 26, 1982, pp. 5 and 6 and App. A.

Table 6

Natural Gas Imports, 1978-81

Year	Source	Quantity (in Tcf)	Price per Mcf
1978	Canada	0.88	$ 2.19
	Mexico	-	-
	Algeria	0.08	1.53
1979	Canada	1.00	2.61
	Mexico	-	-
	Algeria	0.25	2.03
1980	Canada	0.80	4.32
	Mexico	0.10	4.41
	Algeria	0.09	3.77
1981	Canada	0.76	4.83
	Mexico	0.11	5.01
	Algeria	0.04	5.54

Source: Energy Information Administration, U.S. Imports and Exports of Natural Gas, 1981, DOE/EIA-0188(81), June 1982.

The price of imports was above the average well-head price of domestic gas during these years. Domestic gas, on the average, cost $0.90 per Mcf in 1978, $1.18 in 1979, $1.60 in 1980, and $2 06 in 1981. 1/

A notable development relating to gas imports is the proposal by Panhandle Eastern Pipeline to import liquefied natural gas from Algeria. This gas would cost more than $7.00 per MmBtu when landed in Louisiana and more than $8.50 per MmBtu when delivered to distribution companies in the midwest, according to the representative of one such company.

Based in part on Panhandle's stated plans to import this gas, some distributors have projected substantial price increases. However, the imports are being contested and it is not clear how much of the gas will be sold to distributors and at what price.

PRICES CHARGED TO DISTRIBUTORS

Distributors generally buy their supplies from the one, or at most the few, pipelines that serve their area. Terms of trade

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1/Energy Information Administration, Annual Report to Congress, Vol. 2: Energy Statistics, May 1982, DOE/EIA-0173(81)/2, table 53.

between pipelines and distributors are not established by direct negotiation between the parties. Instead, interstate pipeline sales to distributors are governed by tariffs approved by FERC; distributors can be involved in FERC's process for setting such tariffs.

These tariffs establish such conditions as prices, quantities to be supplied, and minimum purchase (or "minimum bill") obligations. The price charged is typically the average price of gas paid by the pipeline plus an amount to cover the pipelines' operating expenses and provide a return on the pipelines' capital investments.

One possible source of increases in prices charged to distributors is the triggering of "minimum bill" provisions. However, representatives of two trade associations representing distributors told us that they were aware of few significant examples of "minimum bill" provisions being triggered.

Other provisions of pipeline distributor tariffs may also restrict the distributors' flexibility in gas supply. For example, an Illinois distributor, Central Illinois Light Company, has complained to FERC about its rate classification with Panhandle Eastern Pipeline. According to a company representative, the distributor stated that its current rate schedule prevents it from buying gas from another pipeline at a lower price and, thus, inhibits the distributor from trying to reduce its gas supply costs.

A second possible source is an increase in pipeline operating expenses and rates of return. According to American Gas Association statistics, the average pipeline share of revenue per Mcf increased at an average rate of 15 percent between 1970 and 1978 and 17 percent between 1978 and 1981. In contrast, during these same two periods the average distributor share of revenue per Mcf increased at average rates of 12 percent and 3 percent, respectively. (See table 3, on p. 8.)

Finally, pipelines' sales to distributors may be affected by declines in pipelines' direct sales to industrial and electric utility customers. According to an investment firm's analysis, such sales are important to pipelines for two reasons.

--Industrial consumption tends to be less weather-sensitive than residential consumption. This "demand constancy not only allows the pipeline to operate more efficiently, but

also to amortize its operating costs over a larger number of units," spread fairly evenly over the year. "Loss of industrial load disrupts this balance, increases a system's weather sensitivity, and forces operating cost recovery onto fewer units," resulting in an increase in the delivered price of gas.

--Moreover, "large volume sales for industrial consumption or for electric generation include the highest margin transactions among pipeline deliveries * * *." 1/

The decline in industrial and electric utility sales between 1981 and 1982 may, therefore, be working to increase prices on pipelines' sales to distributors.

PRICES CHARGED TO END-USERS

Although prices charged by producers and interstate pipelines are regulated by the Federal Government, rates charged by distributors are usually subject to State or local regulation. Accordingly, developments in this area are very diverse.

A significant development in at least some areas of the country is the loss of industrial sales, not only losses already experienced but also anticipated losses, which are due largely to switching from gas to another fuel--often residual (or No. 6) fuel oil. The loss of industrial customers can affect distributors in some of the same ways that it affects pipelines--by reducing the number of units which contribute to paying operating costs and reducing the company's operating efficiency by increasing the company's weather sensitivity.

In an attempt to discourage industrial users from switching to an alternative fuel, distribution companies and State regulators in some areas of the country are considering or have approved rate schedules that would raise rates to residential users by a larger proportion than rates to industrial users. For example, consistent with the State of California's statutes and guidance from the California Public Utility Commission, the distributor serving Los Angeles has had higher average rates for industrial users than for residential users. But, because of concern about users switching from gas, the company has proposed a new rate structure which would place more of the cost burden on residential customers. Rates for industrial users which could switch to residual fuel oil would increase from $4.16 per MmBtu in January 1982 to $5.47 in January 1983, a 31-percent increase. While residential users face an average rate increase of about 70 percent, according to company officials. 2/

1/R. Gamble Baldwin and Robert L. Christensen, Jr., Large Volume Sales of Natural Gas: Their Importance and Vulnerability, First Boston Corporation, Special Report GT 1398.82, Aug. 1982, pp. 10 and 11.

2/Residential rates in January 1982 were $2.83, $3.81, and $5.67 per MmBtu, with higher rates for those who consume more. As of November 30, the California Commission has not acted on the company's proposal.

CONCLUSIONS

Numerous factors have contributed to natural gas price increases before and since enactment of NGPA. End-user rates for natural gas depend on the diverse factors affecting how gas is priced to pipelines, to distributors, and to end-users.

Prices paid by pipelines are based on purchases of both domestic and imported gas. Prices for domestic gas depend on both the quantity of gas in each category and the price for each category; these quantities and prices, in turn, are influenced by many factors, including (1) the NGPA's escalation provisions, (2) incentive prices for high-cost gas, (3) depletion of old fields, (4) recategorization of gas, (5) "take-or-pay" and other clauses in producer-pipeline contracts, (6) Federal regulations, and (7) other factors.

Prices paid by distributors depend, in part, on increases in pipeline operating expenses and rates of return and the loss of direct sales to industrial and electric utility customers. Prices paid by end-users depend, in part, on the allocation of cost increases between residential, industrial, and other users.

CHAPTER 4

CURRENT MARKET CONDITIONS

Reports of increases in retail natural gas prices may seem incompatible with other reports of an "excess supply" of natural gas. This chapter first examines whether such an "excess supply" exists, then discusses reasons which may account for it, and finally considers evidence that the industry is adjusting to current market conditions.

IS THERE AN IMBALANCE BETWEEN GAS PRODUCTION AND CONSUMPTION?

The expected balance between natural gas production and consumption in any time period depends on current production, net withdrawals from or additions to storage, and current consumption. Even if these amounts are known, or can reasonably be predicted, for a given time period on a national basis, conditions facing an end-user will depend largely on the situation of one or more pipelines serving a specific location.

FERC staff have collected information from major interstate pipelines about their expected supply availability for the forthcoming winter heating season (November through March) and actual supplies used during the previous season. (Estimates are prepared for a normal winter and for somewhat colder winters.) These data provide one measure of the balance between production and use.

Data submitted by the companies show that company estimates of available supplies for a normal winter were somewhat higher than actual supplies used in the winter of 1980-81 and very close to equal in the winter of 1981-82. (See table 7.)

Estimates of available interstate supplies for the current heating season total 6,653 Bcf. This level is higher than both estimated supplies available (6,053 Bcf) and actual supplies used (6,037 Bcf) for last winter. Moreover, based on American Gas Association data for gas utility sales during the first 8 months of 1982, it appears likely that this winter's sales will be below last winter's sales. Using the 4.3 percent decline for the first 8 months as a basis of comparison, it is plausible to expect that this winter's sales may total about 5,777 Bcf.

Thus, estimated interstate supplies available for a "normal" winter in 1982-83 are about 10 percent higher than actual supplies used in 1981-82, and about 15 percent higher than a plausible projection of actual supplies to be used in 1982-83. Such differences could be characterized as an "excess supply."

HOW DID THE CURRENT SITUATION DEVELOP?

The current "excess supply" of gas connotes an imbalance between production and consumption. This imbalance may be traced to the various factors which affect both production and consumption.

Table 7

Major Pipeline Companies Estimated and Actual Supplies for Winters of 1980-81, 1981-82, and 1982-83

	Winter heating season		
	1980-81 (note a)	1981-82 (note b)	1982-83 (note b)
Estimated supplies available (normal winter)	6,286	6,053	6,653
Actual supplies used	6,038	6,037	c/ 5,777

a/Based on data for 28 companies.

b/Based on data for 24 companies.

c/GAO estimate based on actual supplies used in 1981-82 and declines in gas utility sales reported by the American Gas Association, Monthly Gas Utility Statistical Report--August 1982. The Association reported that sales during the first 8 months of calendar 1982 were 4.3 percent below previous year levels. Residential sales (3,498 Bcf) were up 6.7 percent; commercial sales (1,728 Bcf) were up 5.6 percent; industrial and electric utility sales (4,780 Bcf) were down 13.9 percent; and other sales (192 Bcf) were unchanged. We assumed that sales during the 5-month winter heating season of 1982-83 would likewise be 4.3 percent below 1981-82 levels.

Source: FERC, Commission Staff Reports: Impact of 1981-82 Winter Gas Supply for Twenty-Eight Pipeline Companies, Docket Nos. TC81-23, et al., October 1981, p. 5, and Commission Staff Report on 1982-83 Winter Gas Supply for Twenty-Four Pipeline Companies, Docket Nos. TC82-12, et al., September 1982, p. 5.

Following the 1954 Supreme Court decision, gas sold in interstate commerce was subject to Federal price controls, although gas sold in intrastate commerce was not subject to these controls. In the early and mid-1970s, competition for new gas supplies pushed intrastate prices well above interstate prices. 1/

This imbalance led to a prolonged decline in the amount of gas reserves under the control of interstate pipelines. During the 11-year period ending in 1977, these pipelines experienced a fall in their inventory of dedicated reserves, from about 198 Tcf in 1967 to about 93 Tcf in 1977. (See table 8.) The pipelines' inventory of reserves dropped from 17 times current production levels in 1967 to 9 times current production levels in 1977. During this period gross changes in reserves (reflecting new reserves plus the net change in assessment of already discovered reserves) were low or negative. In each year gross changes in reserves were less than production. Therefore, the net change in reserves was negative during every year between 1968 and 1977.

Not only was the interstate pipelines' inventory apparently being depleted, but there were many instances in the early and mid-1970s when the pipelines could not deliver as much gas as their customers wanted and therefore had to "curtail," or restrict, purchases by some customers. These curtailments led to the shutting down of factories and schools, especially during the unusually cold winter of 1976-77.

Because of their experience with shortages, interstate pipelines were eager to purchase new supplies throughout the 1970s. Before enactment of the Natural Gas Policy Act in 1978, interstate pipelines faced restrictions in competing against intrastate pipelines and against each other on the basis of current price, so they resorted to competing on other terms. These so-called "non-price" terms included provisions governing: (1) how prices would be set if Federal price regulations ended and (2) how much of the production covered by a given contract would be purchased regularly.

After NGPA, interstate and intrastate pipelines were on a more equal footing with respect to allowable prices, but they still competed aggressively for new supplies. This aggressive competition apparently continued through 1980 and perhaps 1981, even though exploration efforts were considerably higher in those years and the interstate pipelines' reserves were again improving. (See Table 8.)

1/According to the April 1977 National Energy Plan, "Recent contract prices for new gas in the intrastate market range from $1.60 per Mcf to $2.25, while the highest price ever allowed for long-term interstate gas purchases is $1.45." See Executive Office of the President, Energy Policy and Planning, National Energy Plan, Apr. 29, 1977, p. 18.

Table 8

Interstate Pipeline Companies' Dedicated Reserves Changes in Reserves, Production, and Reserves-to-Production Ratios, Alternate Years, 1965-81

Year	Dedicated reserves as of Dec. 31	Changes in reserves from previous years Net	Changes in reserves from previous years Gross	Production	Reserves-to-production ratio (note b)
	(in Tcf)	(in Tcf)	(in Tcf)	(in Tcf)	
1965	192	3	13	10	19
1967	198	3	15	12	17
1969	188	- 7	6	13	14
1971	161	-12	2	14	11
1973	134	-13	1	14	10
1975	107	-14	- 2	12	9
1977	93	- 5	6	11	9
1979	97	3	15	12	8
1981 (note a)	98	1	13	12	8

a/Preliminary.

b/Ratios computed from unrounded data.

Source: EIA, Domestic Natural Gas Reserves and Production Dedicated to Interstate Pipeline Companies, 1981, (Preliminary Report), DOE/EIA-0167(81)P, June 1982, table 3; and Gas Supplies of Interstate Natural Gas Pipeline Companies--1980, DOE/EIA-0167(80), Dec. 1981, table 3.

The results of this competition included

--some contracts which obligated the purchaser to pay the "highest regulated rate" for gas;

--some contracts which obligated the purchaser to purchase 80 or 90 percent of the gas which could be delivered from a given field, which severely limited the purchaser's flexibility;

--some contracts which, until the last year or two, often gave the purchaser little, if any, latitude to initiate renegotiation if the price was too high;

--some contracts to pay $9.00 or more per MmBtu for deep gas;

--some contracts with Canadian and Mexican producers to pay nearly $5.00 per MmBtu at the border; and

--considerable investments in facilities for receiving and handling imports of liquefied natural gas.

Until recently, interstate pipelines could generally sell as much gas as they could provide. In fact, there was assumed to be an unfulfilled demand for gas at existing prices. A report prepared for the Department of Energy estimated that there was "frustrated" or unfulfilled, demand for gas in the industrial sector of almost 2 Tcf in 1979. 1/

However, this supposed unfulfilled demand seems to have disappeared, and 1982 consumption is less than 1981 consumption. Recent consumption of gas has been significantly affected by reactions to higher gas prices and by general economic conditions. In response to sharply higher gas prices, consumers have made more efficient use of their gas and have substituted other fuels for gas. In response to general economic conditions, consumers have cut back on purchases of gas used in producing various goods and services.

The overall effect was the potential to produce large quantities of gas--at high prices. These high prices coincided with, and in some measure led to, declines in consumption. Thus developed the current "excess supply" of natural gas. However, this situation is not necessarily a permanent phenomenon.

HOW IS THE MARKET ADJUSTING?

In the theoretical model of a market described in a basic economics text, an imbalance between supply and demand quickly

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1/Energy and Environmental Analysis, Inc. Industrial Gas Demand, Appendix B to "A Study of Alternatives to the Natural Gas Policy Act of 1978," DOE/PE-0034, Nov. 1981, p. 7.

leads to adjustments which equilibrate supply and demand via the price mechanism. An excess of supply over demand, for example, would be expected to lead to a lower price. The recent behavior of the natural gas market appears to diverge from the behavior predicted by the theoretical model because prices have been rising, even though there is "excess supply" of gas.

Current market conditions reflect the cumulative effects of years of developments in the natural gas industry and regulation. Accordingly, it is not certain how quickly and completely the industry can and will adjust to the current "excess supply."

Natural gas markets have several characteristics which do not conform to the textbook model and which may tend to impede adjustments. These include features of both industry structure and government regulation--which in turn are interrelated. In the former category are long-term arrangements between producers and pipelines and between pipelines and distributors; multiple ownership interests in producing properties, which may make it more difficult to get agreement on renegotiating prices; and limited knowledge of industry developments.

In the latter category are Federal and State ceilings on wellhead prices; Federal regulations which require that a gas reservoir--once "dedicated" to interstate commerce--remains dedicated, unless FERC approves otherwise; and a pipeline's need to obtain FERC approval to increase an existing customer's level of "entitlements" or sell gas to a customer which it is not required to serve.

Nonetheless, there is some evidence that the market is responding. Examples can be found in producer-pipeline relations, pipeline-pipeline relations, and pipeline-distributor relations. This evidence is anecdotal--rather than comprensive--because companies typically are reluctant to divulge their competitive strategy. Much of the available information has come to public attention through FERC proceedings.

In pipeline dealings with producers, perhaps the most dramatic evidence of industry adjustment to changed conditions relates to purchases of high-cost (section 107) gas. This category consists mostly of deep gas (whose price is unregulated) and tight-sands gas (whose price is regulated at a relatively high rate). According to the September 1982 EIA study, 1/ the average price paid by major interstate pipelines for section 107 gas increased from $6.12 an Mcf for mid-1981 filings to $7.33 an Mcf for late 1981 to early 1982 filings, but declined to $7.24 an Mcf for mid-1982 filings (all prices in constant January 1982 dollars).

1/Energy Information Administration, An Analysis of Post-NGPA Interstate Pipeline Wellhead Purchases, DOE/EIA-0357, Sept. 1982, p. 28.

Moreover, some pipelines have exercised "market-out" clauses in contracts for the purchase of deep gas. Transcontinental Pipeline exercised its "market-out" clauses in May 1982; it offered to pay $5.00 per MmBtu, according to a company representative. Three other pipeline companies (United, Michigan-Wisconsin, and Tennessee) have exercised their "market-out" clauses since then, according to their representatives.

In addition, Southern Natural asked its suppliers this past summer to voluntarily reduce their deliveries because its pipelines and storage fields were full and its customers were using less gas than expected, according to a company representative. Columbia is renegotiating contracts with its suppliers to provide for lower prices and lower purchase obligations, according to a company representative.

In terms of pipeline dealings with other pipelines, it should be noted that many pipelines purchase gas from other pipelines. According to the September 1982 EIA report, 9 of 20 major interstate pipelines bought at least 2 percent of their supplies from other pipelines. Columbia Gas Transmission notified five pipeline suppliers in August 1982 that it would neither take nor pay for volumes required by its arrangements with those other pipelines, according to a company representative. Columbia cited a precipitous and continuing deterioration of the markets it serves.

Finally, pipelines' dealings with distributors are also evolving. Some pipelines (including Columbia and Michigan-Wisconsin) have applied to FERC for approval of a temporary discount rate for industrial customers. These rates are available for pipeline sales to distributors, for resale to qualified industrial customers. Such lower rates are designed to discourage major industrial users from switching from gas to another fuel, such as residual fuel oil.

In summary, although most of the information is anecdotal, there is a growing body of evidence that the natural gas market is acting to reduce prices and otherwise adjust to the current "excess supply."

CONCLUSIONS

Reports of an "excess supply" of natural gas are consistent with major pipeline estimates of supplies which will be available this winter. This situation reflects the many factors which determine gas production and consumption. Until recently, pipelines could generally sell as much gas as they could provide and eagerly sought new supplies.

However, there no longer seems to be any unfulfilled demand at current prices, and consumption through the first 8 months of 1982 was below the comparable 1981 level. The current situation thus resulted from pipelines' potential to supply large quantities of gas and a coincident decline in gas consumption.

Some companies are adjusting to the current situation, by exercising "market-out" clauses, renegotiating contracts, and other means, according to their representatives. However, various industry and regulatory characteristics may act to impede the pace of adjustment.

The CHAIRMAN. Senator Danforth.

STATEMENT OF HON. JOHN C. DANFORTH, A U.S. SENATOR FROM THE STATE OF MISSOURI

Senator DANFORTH. Thank you very much, Mr. Chairman. I think that the major points have been pretty well covered by the preceding witnesses, but I do have a statement that I would like to submit for the record.

The CHAIRMAN. It will be made a part of the record.

Senator DANFORTH. Thank you very much. I would simply like to make a few summary comments on my fuller statement.

Mr. Chairman, there is absolutely no doubt that there is a real crisis which we are facing in this country and I think that that crisis is well exemplified by the plight of the people in western Missouri right now. The gas service company of Kansas City reports that last year's price increases by themselves have resulted in 8,000 cutoffs of gas service as this heating season begins, but the worst is yet to come.

The company also reports that its cost of gas will rise nearly 50 percent from January 1982 to January 1983. As a result of that 50-percent increase in cost of gas to the gas service company in Kansas City, the cost of gas to consumers is expected to go up something like 37 percent and this in turn means that according to the projections of the gas service company of Kansas City, the number of cutoffs will increase from about 8,000 people who have now been cut off to about 10,000 to 12,000 people at the end of this winter, simply because people are unable to pay their bills to the gas company.

Now, particularly in western Missouri, and I understand in other parts of the country as well, a significant portion of the problem is related to the existence of take-or-pay contracts. The gas service company of Kansas City has available to it right now natural gas from Kansas from the Hugoton field in Kansas with an average cost of 50 cents per 1,000 cubic feet. However, the gas service company is locked in to contracts for natural gas from $6 to $9 per 1,000 cubic feet.

And according to the advice that I got from the company in Kansas City, if we were able to get them out from under the take-or-pay contracts, the result of that would be a reduction in the cost of natural gas to consumers in western Missouri and eastern Kansas of about 25 to 30 percent. And that is exactly what the amendment or the bill that Senator Eagleton and I and others have introduced with respect to take-or-pay contracts is intended to do.

The provision is very simple and straightforward. It would void any contract clause that requires payment for gas not taken. If such a clause is necessary to avoid a loan default by the producer, the Federal Energy Regulatory Commission would have the power to reinstate or modify it to the extent necessary.

The amendment also gives the Commission the power to reduce the charges for purchased gas that pipelines pass along to distribution companies if the pipeline imprudently fails to obtain the least cost mix of gas. Currently the Commission's only grounds for denying such costs are waste and fraud and the Commission interprets those criteria very narrowly.

Mr. Chairman, just one other point that I would like to make, and as Senator Eagleton pointed out the number of letters that he has received on the question of natural gas pricing, I am in the same situation. There are literally thousands of letters coming in on the subject. I think it is one of the most, if not the most significant question on the minds of our constituents right now.

I would just like to read from one letter from a couple in a small town in the western part of our State. The letter says this:

> We have worked hard all our lives. We are 68 and 73 years old and sit and watch our life savings going out for electric bills and high heat bills, and we are not the only ones. We have to watch every penny to live half-way decent. Born and raised in Missouri and never on welfare, just worked all our lives, I think we deserve more.
>
> These bills are no longer reasonable when you just have heat on about 2 hours a day. Please try and do something for the poor working people of Missouri.

And that is just a typical comment, Mr. Chairman, on the part of people all over our State and I am sure all over the country. I don't think that any member of this particular panel of Senators has a history of trying to gum up the business of the Senate or trying to take advantage of the situation in a lameduck session or when everybody wants to go home for Christmas, but I do think we feel very strongly that this is not a matter which can be studied at great length and at leisure.

It is a matter of real urgency to human beings who are having a very difficult time and it is my hope that we can get on with the business of providing relief for these people within the next few weeks.

The CHAIRMAN. Thank you very much.

Senator DANFORTH. Mr. Chairman, if I may, I have a letter from the Governor or our State, Governor Bond, which he has written to you and I would like to submit that to you and to the record.

The CHAIRMAN. That will be made a part of the record at this point.

[The prepared statement of Senator Danforth and letter from Governor Bond follow:]

STATEMENT OF SENATOR JOHN C. DANFORTH

December 13, 1982

Mr. Chairman, rising natural gas prices are creating a genuine crisis in my state and in other states that rely on this fuel for home heating. The rapid escalation of gas costs is causing serious hardship, not only to the poor and the elderly, but also to a broad range of people with moderate incomes, whose budgets can't stand the sudden jolt that this winter's heating bills will cause.

The Gas Service Company of Kansas City reports that last year's price increases by themselves have resulted in 8,000 cutoffs of gas service as the heating season begins. But the worst is yet to come. The company also reports that its cost of gas will rise nearly 50 percent from January 1982 to January 1983. Other areas face increases that are just as alarming. The Bureau of Labor Statistics reported on Friday that natural gas prices had increased nationwide by 25.7 percent between November 1981 and November 1982--5 percent in the last month alone. More than 53 percent of all U. S. households depend on natural gas for home heating, and according to one survey of public utility commissions, as many as 300,000 households on natural gas may have their heat cut off this winter.

One of the central aims of the Natural Gas Policy Act was to cushion--by a policy of gradual decontrol--the transition from 25 years of regulated gas prices to a free market environment. I was a supporter of the NGPA, but I must say that in this aim it has

FAILED. GAS PRICES HAVE MORE THAN DOUBLED--AND IN SOME CASES TRIPLED--IN THE FOUR YEARS SINCE PASSAGE OF THE NGPA, INCREASING AT AN ANNUAL RATE OF MORE THAN 21 PERCENT. INDEED, IT APPEARS THAT IN MANY AREAS WE HAVE REACHED THE MARKET CLEARING PRICES THAT WERE THE GOAL OF THE ACT--TWO YEARS AHEAD OF SCHEDULE AND AT A LEVEL NO ONE ANTICIPATED. AND THERE IS NO END IN SIGHT.

AS A RESULT OF THESE RISING PRICES, NEW GAS DISCOVERIES, AND A SLUMPING NATIONAL ECONOMY, THERE IS MORE GAS OUT THERE THAN CAN BE SOLD. BUT THE MARKET IS NOT WORKING AS IT SHOULD--THAT IS, WITH STABLE OR FALLING PRICES--AND ONE REASON IS QUITE CLEAR: TAKE-OR-PAY CONTRACT CLAUSES.

VERY SIMPLY, THESE CLAUSES BIND A NATURAL GAS PIPELINE COMPANY TO PAY FOR GAS IT HAS CONTRACTED FOR, WHETHER IT TAKES THE GAS OR NOT. PRODUCERS DEMANDED THESE CLAUSES DURING THE MID-1970'S, WHEN GAS SUPPLIES WERE SHORT, AND PIPELINES AGREED TO THEM FOR FEAR OF GETTING CAUGHT SHORT OF GAS IF THEY DIDN'T.

NOW CIRCUMSTANCES HAVE CHANGED, AND THE PIPELINE COMPANIES HAVE MORE GAS THAN THEY CAN SELL. BECAUSE OF THESE TAKE-OR-PAY CONTRACT CLAUSES, THEY ARE BUYING HIGH-PRICED GAS--AT THE SAME TIME THAT THEY ARE TELLING PRODUCERS OF CHEAP GAS TO CAP THEIR WELLS. FOR EXAMPLE, GAS WITH AN AVERAGE COST OF 50 CENTS PER 1,000 CUBIC FEET IN KANSAS'S GIANT HUGOTON FIELD IS BEING SHUT IN, WHILE GAS COSTING FROM $6 TO

$9 CONTINUES TO FLOW. SIMILARLY, SMALL PRODUCERS IN NEW MEXICO FIND THEMSELVES UNABLE TO SELL GAS AT $2 AND $3 TO A COMPANY THAT IS PAYING $8 TO OKLAHOMA PRODUCERS AND THEN SHIPPING IT ALL THE WAY TO CALIFORNIA. IN APPALACHIA, 45-CENT GAS IS BEING REFUSED IN FAVOR OF $8 GAS FROM THE SOUTHWEST.

IN SUCH A SITUATION, GAS PRICES CAN RISE EVEN WITHOUT INCREASES IN WELLHEAD PRICES. INDEED, THE DEPARTMENT OF ENERGY SAYS THAT BETWEEN 56 AND 75 PERCENT OF THE RECENT INCREASES IN PRODUCER REVENUES SHOULD BE ATTRIBUTED TO CHANGES IN THE MIX OF GAS. FOR EXAMPLE, IF A PIPELINE HAS ACCESS TO $5 GAS AND 50-CENT GAS, SHIFTING FROM A 50-50 BLEND TO A 60-40 BLEND INCREASES PRICES BY MORE THAN 16 PERCENT--WITH NO CHANGE IN THE WELLHEAD PRICE PAID TO PRODUCERS.

AS A RESULT, CONSUMERS ARE GETTING A DOUBLE OR EVEN TRIPLE WHAMMY: RISING PRICES HAVE REDUCED DEMAND--THUS, THERE IS LESS LOW-COST GAS IN THE BLEND TO KEEP PRICES DOWN; NEW, HIGHER-COST GAS CONTINUES TO RISE IN PRICE UNDER THE NGPA; AND IN SOME CASES INDUSTRIAL CUSTOMERS ARE SWITCHING TO ALTERNATE FUELS, CHIEFLY OIL. THIS LAST RESULT IS NOT ONLY CONTRARY TO OUR NATIONAL POLICY OF REDUCING OUR RELIANCE ON OIL, BUT MORE IMPORTANTLY, IT REDUCES THE NUMBER OF CUSTOMERS SHARING THE FIXED COSTS OF THE NATURAL GAS SYSTEM AND DRIVES PRICES UP FURTHER.

THE AMENDMENT I INTEND TO PROPOSE TO THE HIGHWAY/GAS TAX BILL, ALONG WITH SENATOR EAGLETON AND OTHERS, IS SIMPLE AND STRAIGHTFORWARD:

IT VOIDS ANY CONTRACT CLAUSE THAT REQUIRES PAYMENT FOR GAS NOT TAKEN. IF SUCH A CLAUSE IS NECESSARY TO AVOID A LOAN DEFAULT BY THE PRODUCER, THE FEDERAL ENERGY REGULATORY COMMISSION WOULD HAVE THE POWER TO REINSTATE OR MODIFY IT TO THE EXTENT NECESSARY.

THE AMENDMENT ALSO GIVES THE COMMISSION THE POWER TO REDUCE THE CHARGES FOR PURCHASED GAS THAT PIPELINES PASS ALONG TO DISTRIBUTION COMPANIES IF THE PIPELINES IMPRUDENTLY FAIL TO OBTAIN THE LEAST-COST MIX OF GAS. CURRENTLY, THE COMMISSION'S ONLY GROUNDS FOR DENYING SUCH COSTS ARE WASTE AND FRAUD, AND THE COMMISSION INTERPRETS THOSE CRITERIA VERY NARROWLY.

THIS AMENDMENT DOES NOT PURPORT TO DEAL WITH THE WHOLE RANGE OF NATURAL GAS ISSUES. WITHOUT QUESTION, FURTHER CONSIDERATION TO THIS SUBJECT WILL HAVE TO BE GIVEN BY THE 98TH CONGRESS. INDEFINITE PRICE ESCALATOR CLAUSES, FOR EXAMPLE, ARE A TICKING TIME BOMB SET TO EXPLODE WITH THE ARRIVAL OF DECONTROL. STRIKING DOWN TAKE-OR-PAY CLAUSES, HOWEVER, IS ONE WAY THAT WE CAN PROVIDE RELIEF TO CONSUMERS THIS WINTER. AND IT IS A SOLUTION THAT OPENS UP THE MARKET, INSTEAD OF REGULATING IT FURTHER.

AT PRESENT, PIPELINES ARE PREVENTED BY TAKE-OR-PAY CLAUSES FROM RESPONDING TO CHANGED MARKET CONDITIONS; YET THEY ARE NOT PENALIZED FOR THE BAD JUDGMENT THEY SHOWED IN SIGNING THESE CLAUSES--AS BUSINESSES WOULD BE IN AN ORDINARY MARKET ENVIRONMENT. THE PIPELINES

CAN SIMPLY PASS ALONG THE HIGHER GAS COSTS TO CONSUMERS. ELIMINATION OF THESE CLAUSES WOULD ALLOW PIPELINES TO BUY THE CHEAPEST GAS AVAILABLE AND PASS THOSE SAVINGS BACK TO CONSUMERS. NOT NEXT YEAR, NOT IN 1985, BUT NOW.

IT IS FOR THIS REASON--THE NEED FOR IMMEDIATE RELIEF--THAT THE AMENDMENT DOES NOT SIMPLY GIVE FERC THE POWER TO ABROGATE TAKE-OR-PAY CLAUSES. WE CANNOT SIT BY AND WAIT FOR THE OUTCOMES OF ENDLESS PROCEEDINGS AND APPEALS WHILE THE CONSUMER CONTINUES TO PAY THESE UNFAIR AND UNNECESSARY GAS COSTS: WE SHOULD ACT NOW, ALLOWING FERC TO REINSTATE SUCH CLAUSES ONLY IF NECESSARY TO PROTECT SMALL PRODUCERS WHOSE ENTIRE BANKROLL DEPENDS ON THEM.

IF THIS AMENDMENT IS ENACTED, CONSUMERS WOULD BENEFIT FROM LOWER NATURAL GAS PRICES. DISTRIBUTION COMPANIES AND PIPELINE COMPANIES WOULD BENEFIT FROM AN INCREASED ABILITY TO MARKET THEIR PRODUCT TO INDUSTRIAL CUSTOMERS. AND MANY GAS PRODUCERS WOULD BENEFIT FROM AN INCREASED ABILITY TO SELL EXISTING, CHEAP GAS THAT THEY NOW CANNOT DISPOSE OF.

MR. CHAIRMAN, LET ME CONCLUDE BY SHARING WITH MY COLLEAGUES A LETTER FROM A COUPLE IN A SMALL TOWN IN THE WESTERN PART OF MY STATE. IT IS A LETTER THAT SAYS, FAR MORE ELOQUENTLY THAN I CAN, WHY WE NEED TO ACT TODAY TO CUT THE RISING PRICE OF NATURAL GAS. THE LETTER READS AS FOLLOWS:

"WE HAVE WORKED HARD ALL OUR LIVES. WE ARE 68 AND 73 YEARS OLD AND SIT AND WATCH OUR LIFE SAVINGS GOING OUT FOR ELECTRIC BILLS AND HIGH HEAT BILLS, AND WE ARE NOT THE ONLY ONES.

"WE HAVE TO WATCH EVERY PENNY TO LIVE HALF WAY DECENT. BORN AND RAISED IN MISSOURI AND NEVER ON WELFARE, JUST WORKED ALL OUR LIVES, I THINK WE DESERVE MORE.

"THESE BILLS ARE NOT LONGER REASONABLE WHEN YOU JUST HAVE HEAT ON ABOUT 2 HOURS A DAY. PLEASE TRY AND DO SOMETHING FOR THE POOR WORKING PEOPLE OF MISSOURI."

THANK YOU FOR ALLOWING ME TO TESTIFY TODAY.

EXECUTIVE OFFICE
STATE OF MISSOURI
P. O. BOX 720
JEFFERSON CITY
65102

CHRISTOPHER S. BOND
GOVERNOR

December 9, 1982

The Honorable James A. McClure, Chairman
Committee on Energy and Natural Resources
3106 Dirksen Senate Office Building
Washington, D. C. 20510

Dear Mr. Chairman:

The Senate Committee on Energy and Natural Resources is considering several measures to amend the Natural Gas Policy Act of 1978. I am deeply concerned about the large increases in the price of natural gas which Missouri consumers have experienced as a result of this Act. Since its passage in 1978, prices for natural gas have risen an average of thirty percent a year in Missouri. Many of our residential gas customers have experienced a forty percent increase in prices over last winter.

These unprecedented increases in natural gas prices represent an unreasonable burden on thousands of Missouri consumers who are trying to stay warm each winter. Sixty-five percent of all Missourians rely on natural gas as a primary heating source. Consequently, these price increases have had a serious negative economic impact in Missouri over the past four years.

There are several reasons for this problem, but chief among them is the Natural Gas Policy Act of 1978. This Act was intended to provide gradual increases in the price of natural gas. Instead, increases have occurred which are more than three times the annual inflation rate. It is clear that the Act is not functioning as envisioned and that changes in the federal price increase mechanisms must be made immediately.

A second major cause of high gas prices is take-or-pay clauses in contracts between natural gas producers and pipeline companies. As you know, these are long term supply contracts for high-priced gas which require pipelines either to take delivery of contracted gas or pay for a large percentage of it, even if the pipeline has no market for the gas at the time of delivery. This problem has, in turn, caused pipelines to cancel their contracts with lower priced gas suppliers in order to sell consumers the gas they were required to take under their take-or-pay contracts. The overall result is artificially inflated prices for the consumer.

I am doing everything I can to help my fellow Missourians cope with this problem. For example, I recently appointed a Governor's Task Force to review assistance programs available for those unable to pay their gas bills. In addition, I worked hard for the passage of a State home weatherization program during the last session of our legislature, which is currently being implemented. However, a comprehensive solution is the only realistic approach to this complex issue and I believe it must come from the federal level. For this reason, I strongly urge passage of S. 3069, S. 3070 and S. 3071, the natural gas legislation co-sponsored by Senators Danforth and Eagleton. I support S. 3069, which would impose a two year freeze on natural gas prices, because it would give consumers immediate relief while allowing Congress time to amend the Natural Gas Policy Act so that these problems do not recur. S. 3070 would help consumers by prohibiting use of take-or-pay clauses in natural gas sales contracts, which artificially inflate gas prices. Finally, I support S. 3071 because it would increase funding levels for low income energy assistance and thus help those with the fewest resources deal with skyrocketing natural gas prices.

Sincerely,

Christopher S. Bond

GOVERNOR

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The **Chairman**. Let me say to my colleagues at the table who are testifying, I am sure every member of this committee, certainly the chairman of it, shares your concerns that have been expressed here this morning.

Senator Exon.

STATEMENT OF HON. J. JAMES EXON, A U.S. SENATOR FROM THE STATE OF NEBRASKA

Senator **Exon**. Mr. Chairman, and members of the Energy Committee, I certainly appreciate the opportunity to participate in the committee's hearing today on the natural gas market. I simply want to add my voice to those that have been already expressed here with regard to the dire circumstances that face consumers in general today with regard to gas prices.

As you know, this issue is important to my State and other Midwestern States which not only depend on natural gas for home heating in the winter, but also depend on this energy resource to support agricultural production. Crop drying, propane, and fertilizer prices are all greatly influenced by the natural gas market.

Last April, the Congressional Research Service completed a study which I had requested regarding the impact of soaring natural gas prices on the farming sector. This report stated that accelerated or full decontrol of natural gas prices, which the administration had been contemplating at that particular time would add up to $2.5 billion to farm production expenses over the next 3 years.

I need not remind the members of this committee, many of whom are from agricultural States, that the farm economy is in dire straits, indeed, experiencing near depression levels in activity. Commodity prices are failing to keep pace with rising production costs of which energy is a major component.

With the rush to deregulation in many industries it was assumed that consumers would benefit. This has not been the case in the gas industry.

In agriculture, we recognize that one reason for drastically low-farm prices is our production or at least our inability to market profitably our production. For example, grain prices are ruinous to producers because of a real or assumed over-production.

This is described as the "free market, free enterprise system at work." If that be true, why is it that the same theory does not apply to the natural or bottled gas industry?

It may be that despite ever-increasing and certainly plentiful gas supplies the take-it-or-pay contracts of recent years are the true culprit of today's price increases.

Last March I appeared before your committee outlining my concerns. A copy of my presentation for the record is presented and for your information and I further present a report from the Congressional Research Service of April 29, 1982, which I requested on price increases in the industry as it affects agriculture, and, of course, generally the same consequences are felt by consumers in general.

Nearly all of the Nation's consumers are feeling price hikes up to 25 percent or more in some cases for home heating costs in their gas bills this winter. These price increases are certainly puzzling in view of the current market conditions. The Federal Energy Regulatory Commission has reported that nationwide, pipelines have about 10 percent or more above their availability of last year at the same time. In addition, wellhead purchases of natural gas have fallen on the average of 2 percent from last year. Yet, according to the Department of Energy consumer prices have risen at least—and I emphasize at least—an average of 17 percent over last year.

Unless, Mr. Chairman, this is a part of the "new economics" the normal forces of supply and demand do not seem to be working here. Under supply conditions that presently confront us, I think we would have to say that burner-tip prices should be trending downward and the opposite is true.

The Congress must certainly make supreme efforts to determine where the responsibility lies for the nonmarket behavior of natural gas prices. The Natural Gas Policy Act of 1978 established maximum lawful ceiling prices only for certain categories of natural gas.

The act did not dictate that these ceiling prices ought to actually be the contract price for natural gas. Contract prices for natural gas can be lower than the ceiling prices established by the act.

I am not certain whether the NGPA has encouraged the present anomaly in the law of supply and demand or whether the industry itself, both pipelines and producers, have failed to adjust to a partially deregulated natural gas market. These are questions to which the Congress must seek answers to and soon, before we tamper further with the natural gas market.

In closing, I would simply emphasize that along with the freedom which accompanies deregulation efforts, goes the responsibility which the pipelines and the producers have whenever they are involved in natural gas pricing, drilling, production, and certainly they have a responsibility to act on this problem without the government stepping in to do so unless there is no other way.

The failure of the industry to anticipate the market and adjust to changes in that market can only build a case for forces of regulation. Proposals to freeze natural gas prices and to cap prices on already deregulated gas have strong appeal in the face of our current economic problems.

Last March, I testified before this committee, and raised the question to the industry as to why it was not doing something to prepare for the advent of decontrol. At that time last March, I asked the industry whether it was waiting for the government to tell them what to do next or whether the industry was taking the initiative to negotiate and resolve among the pipelines and producers the multitude of contractual difficulties and supply problems.

In addition, at that same hearing, I brought to the committee's attention a Merrill Lynch study which suggested that gas prices may well have already reached market clearing levels. To date, I know of only a handful of pipelines and producers who are focusing upon this problem and are renegotiating contract prices and supplies.

This Senator from Nebraska is anxious to hear from witnesses and the committee on the causes and the possible remedies for the current natural gas problem. Unfortunately, it appears that the Congress can do little for consumers' heating bills in the near term, except to offer a small glimmer of hope for the long-term, that the industry will meet the challenges of partial deregulation head-on.

I thank the Chairman.

[The attachments to Senator Exon's statement follow:]

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NATURAL GAS DECONTROL

Mr. EXON. Mr. President, we are all aware of the high price of energy these days, especially with regard to any changes that are suggested in the Natural Gas Policy Act of 1978.

Yesterday, I testified before the Senate Committee on Energy and Natural Resources. I ask unanimous consent that my remarks be printed in the RECORD.

There being no objection, the statement was ordered to be printed in the RECORD, as follows:

STATEMENT BY U.S. SENATOR J. JAMES EXON

Mr. Chairman, and Members of the Energy Committee, I am pleased to come before you today to participate in this hearing in an effort to focus some attention on issues facing the Congress on the matter of natural gas decontrol.

I was encouraged at President Reagan's announcement earlier this month not to pursue legislation to accelerate the decontrol schedule of natural gas prices. The President's retreat from that proposal, I believe, was the result of the hard labors of many of the Members of this Committee who had expressed their deep concerns over accelerating the decontrol of natural gas in these difficult economic times.

It is unfortunate, however, that the President has only shifted the forum of this issue from the Congress, to the Federal Energy Regulatory Commission. The Chairman of that Commission, Mr. Charles M. Butler III, appointed by President Reagan to that post, has publicly announced his intention to pursue accelerated decontrol of several different categories of gas, including so-called "old gas", through administrative rulemaking. Chairman Butler has indicated that, in light of Congressional inaction and apparent opposition to decontrol legislation beyond the 1978 Natural Gas Policy Act, he will pursue an end-run around the legislative branch of the Federal government on this matter.

President Reagan has not objected, publically at least, to this strategy by his Chairman. I must express to the Committee that this concerns me.

I would hope that this Committee, several of the Members of which were instrumental draftsmen of the Natural Gas Policy Act of 1978, will consider two major concerns of this Senator from the State of Nebraska, in reviewing the 1978 law over the next few days, weeks, and months.

First of all, the Committee must consider the impact of accelerating the decontrol schedule on our economy in general, and upon agriculture in particular.

Second, I believe that a major question of policy must be considered by the Committee. What we have here is an executive agency, composed of—in the President's own words—"unelected bureaucrats", taking a national policy initiative that properly belongs to the United States Congress.

As a farm belt Senator, I am deeply concerned about the impact of accelerated decontrol on agriculture. The farming sector of our nation would be hit with a double-barreled blow if natural gas prices are permitted to jump even faster than under the current law.

As you all know, this past week, we recognized "National Agriculture Day", however, there was nothing to celebrate. American agriculture has already been thrust into a severe economic slump. Farmers, the backbone of our nation's economy, are staring into the face of some of the lowest ever farm prices, rising production costs and high interest rates. Net farm income adjusted for inflation, is nearing 1938 levels. Feedgrain exports are predicted to be down by 6 percent, and corn prices, now about $2.63 per bushel, are down 23 percent from last year.

Higher natural gas prices will force up the costs of production for the agriculture sector as the costs of fertilizer and other operating expenses increase to reflect accelerated decontrol. Some studies have shown that overall production costs for the farm economy would increase over and above current levels by $8.2 billion in the next three years. Nebraska farmers alone could shoulder as much as $417 million of those increased costs. Such increases will be reflected, for example, in the price of nitrogen fertilizer. Costs could soar from the current $250 a ton, to upwards of $620 a ton, adding as much as 26 cents to the cost of producing a bushel of corn. In addition, irrigation which utilizes natural gas, would jump 50 percent beyond current increases under an accelerated decontrol scheme.

Of course, it is highly likely that the farmer will be unable to pass such costs along in the price of his product. Food prices would be indirectly affected nontheless. Also, goods and services dependent upon natural gas would cost more, and only add to inflation and upward pressure on interest rates.

I certainly believe that the scope of this Committee's examination of the impact of accelerated decontrol, must go beyond the higher costs which will be paid by millions of American homeowners whose gas bills could double under an accelerated decontrol plan. Residential customers will also be paying more for both heating and eating. Residential customers will also be picking up price hikes passed on by industrial and commercial users in the costs of goods and services.

Speaking briefly for my own State of Nebraska, I would point out as an example of a typical grain-belt economy, that the impact of accelerating the decontrol schedule would be devastating. Nearly 70% of the residential homes in my state are heated with natural gas. This accounts for nearly 40% of the total gas use in Nebraska. Commercial and industrial use of natural gas accounts for about 50% of total gas use, and agriculture about 8% of total gas use. Over 30% of the irrigation units in the state utilize natural gas or propane to power their engines. In addition, many small municipal power plants use natural gas at peak load generation.

On the question of policy, I believe that it is incumbent upon this Committee to examine the actions proposed by the Chairman of the Federal Energy Regulatory Commission to determine whether such action is appropriate within the intent of the language of the NGPA. Chairman Butler has admitted that some of his proposals which he seeks to implement "would be testing the frontiers of the Commission's authority." I would suggest to the Members of the Committee that, at stake in such an experiment is nothing less than the basic health of the American economy and the fundamental authority of the Congress.

A basic inquiry which the Committee must ask is, what is to be gained by accelerating the decontrol of natural gas prices?

Already, the average wellhead price for natural gas has been rising, according to some Wall Street analysts, at an approximate rate of 30 percent for the last two years. Producers have been aggressive in seeking the maximum ceiling price, prices of deep gas and tight formations have been rising rapidly, and old gas is being depleted and replaced with high-priced new gas. New gas currently receives a price rise each year at the rate of inflation, plus a real growth factor of 4 percent under the NGPA. Producers, however, are hollering for more, and not tomorrow, but now.

Drilling activity has soared since the passage of the NGPA. For 1981, the American Gas Association has reported that rig-counts are at an all time high. Well completions for gas have been reported up 7.3 percent over last year. Our drilling capacity however, has been reported to be at maximum capacity. Our production potential is reported to be steadily declining, and despite the increase in drilling activity, reserve additions are expected to remain constant due to the realities of our rescurce base.

I believe the Committee must ask the industry, how much will accelerated decontrol add to our overall gas supplies that the current NGPA will not or has not?

On another matter, much concern has been raised about the so-called price spike which may occur in 1985 under current law. I believe that the Committee must examine this issue to determine whether or not this is a valid concern. A recent, January 1982 study by Merrill Lynch has concluded that this price spike will not occur. Although much will depend upon the uncertainties of the oil market, if Merrill Lynch is correct, a major reason for accelerated decontrol has become a red-herring.

Furthermore, I believe that this Committee must ask the industry itself what it is doing to prepare for the advent of decontrol under the NGPA in 1985. Is the industry, particularly the pipeline companies, waiting for the government to tell them what to do next, or is the industry taking the initiative to negotiate and to resolve among themselves the multitude of contractual difficulties and supply problems?

In closing, let me say to the Members of the Committee that I believe a very detailed record must be made before we tamper with the delicate balance of interests embodied in the Natural Gas Policy Act of 1978. Are we seeking to increase our nation's supply of natural gas by accelerating price decontrol? Or are we merely adding to the coffers of the major oil companies who produce nearly all of our gas supplies? Are we seeking the appropriate balance for a national policy? Or are we shuning our responsibilities to the American public?

I thank you for the opportunity to address the Committee regarding my concerns about this matter.

GAS PRICE SPIKE VIEW OF DECONTROL CHALLENGED

Natural gas decontrol will not produce a big price spike after 1985, but it will spur a definite change in U.S. gas drilling patterns, according to Merrill Lynch Pierce Fenner & Smith Inc., New York.

In and outlook paper, Donald D. Dufresne, vice-president of the investment banker's Securities Research Division, contends that the natural gas industry need not be concerned about a substantial price fly-up after decontrol.

"At the end of 1984, based on an annual inflation rate of 8%, we estimate that the average price of natural gas will be $3.75/MMBTU. Consequently, if the average wellhead price after decontrol is in line with our estimate of $4-$4.25/MMBTU, a dramatic price spike will not occur," the paper says.

"In fact, our estimates indicate that if the Natural Gas Policy Act (NGPA) were to remain in effect beyond Jan. 1, 1985, the average price of gas in that year would approximate $4-$4.25/MMBTU, which is also our decontrolled price estimate."

Noting that the average wellhead price of natural gas in a decontrolled environment is still being "deciphered," Dufresne outlined Merrill Lynch's 1982 price estimates based on the current NGPA decontrol schedule.

PRICE OUTLOOK

The average wellhead price could rise to about $2.40-$2.50/MMBTU in 1982, up from $1.85/MMBTU in 1981. The average price calculations assumed that so-called Section 102 gas, now priced at about $3/MMBTU, will rise to about $3.15/MMBTU late in 1982, while Section 103 gas, now $2.57/MMBTU will cost about $2.65/MMBTU later this year. Together the two categories of gas would comprise about 45% of total 1982 production, the report says.

Tight gas, near deep gas, and deep water gas prices will average $5.15-$5.30/MMBTU, and combined account for 10% of 1982 production. Alone, deep gas is expected to receive prices averaging $7-7.50/MMBTU and account for as much as 4% of total production.

About 40% of the remaining gas production in 1982 is expected to be in the older categories established under the NGPA, with prices averaging $1.25-1.50/MMBTU.

One thing decontrol will produce is drilling activity in the deeper zones, while kicking off accelerated drilling at depths of about 10,000 ft. Such a development would hurt deep drillers and producers.

"If our projections are correct, the excessive cost of drilling the majority of deep wells may render those wells uneconomical to drill. That could put an end to exploration in the deep Tuscaloosa Trend of southern Louisiana as well as some portions of the Anadarko basin," according to report.

Also after decontrol, reserve additions will catch up with production, it added.

DEMAND, SALES

Demand for natural gas is expected to rise modestly this year.

But, because of a listless economy, the current surplus of 1-1.5 trillion cu ft will grow to 1.5-2 trillion cu ft by yearend.

The surplus will continue until industrial gas use increases.

Gas sales in 1982 are projected to be 20.7 trillion cu ft, compared to about 20.4 trillion cu ft in 1981. The sales growth rate of the past few years will slow as gas prices rise in the remainder of the decade.

Intrastate pipelines and natural gas processing companies, however, will experience increased sales in 1982, due mainly to the fact that major oil companies are expected to have trouble meeting their gas customers' needs.

Another casualty of the gradual price hike for natural gas will be processing plant construction, which boomed in January 1980 when natural gas liquids prices were decontrolled.

Building plants will be less attractive as prices rise and the industry's profit margin erodes steadily during the next few years.

Slack demand for gas from the petrochemicals industry also will hold down building and keep the price of gas liquids at about 45-47¢/gal this year.

THE 1980S

Overall, the natural gas industry will face bigger obstacles during the rest of the decade than it did during the gas short 1970s.

Uncertainty over natural gas prices after decontrol will tend to make producers cautious, according to Merrill Lynch.

While accelerated decontrol legislations is not expected to win congressional approval this year, the battle will heat up.

Dufresne sees passage possible in 1963, "but not without a bitter struggle."

More likely, he adds, decontrol will occur as scheduled in NGPA, which doesn't call or decontrol of all natural gas.

And, the faster decontrol occurs the more ifficult it will be to market supplemental gas supplies. Pipelines will have less low rice gas with which to average higher riced supplemental supplies.

Among the projects that stand the greatst chance of losing their competitive edge re the proposed Alaskan pipeline, synthetic uels industry projects, and Canadian and rgentinian gas exports.

Import of Algerian LNG by the U.S. is nore financially promising, the report says.

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EFFECTS OF NATURAL GAS DECONTROL ON FARMING COSTS AND INCOME

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EFFECTS OF NATURAL GAS DECONTROL ON FARMING COSTS AND INCOME

Increases in natural gas prices due to accelerated or full decontrol of natural gas wellhead pricing are likely to have a noticeable effect upon the costs of production in farming. The likelihood that these additional costs can be recovered by the farmer in the market for farm products, however, is small. On the one hand, increases in wellhead prices of natural gas are likely to be passed through both by gas pipelines supplying this fuel to farmenrs and by producers of nitrogenous fertilizers, which attempt to set prices on the basis of costs. On the other hand, as a seller of farm products, the farmer receives a price determined by the vagaries of present and expected shifts in demand and supply in an open market. This price is unlikely to reflect changes in gas prices in the short run. Thus, it is quite possible that farmers will be caught in a profit squeeze owing to higher costs of production incurred by rising natural gas prices. This report presents an analysis of the effects of alternative natural gas pricing schemes on costs of production in wheat and corn farming, based on scenarios involving decontrol commencing in 1982 developed by the U.S. Department of Energy.

Production costs could rise from 1980 to 1983 by about 11 cents per bushel of corn and about 7 cents per bushel of wheat under an accelerated decontrol pricing mechanism, and by about 12 cents per bushel of corn and 7 cents per bushel of wheat under immediate or full decontrol of natural gas wellhead prices. Under the present pricing provisions of the Natural Gas Policy Act (NGPA), costs of raising corn would rise by about 3 cents per bushel from 1980 to 1983, and costs of raising wheat by 2.3 cents per bushel. The decontrol scenarios involve an increase of between 55 and 60 percent in the natural gas component of farming costs over what the farmer would incur under NGPA in 1983. If, as we suspect, farmers could not pass these costs through to buyers of farm products, these costs would absorb an additional 3 percent of farm cash receipts in 1983 under accelerated decontrol, and 7 percent of farm cash receipts in 1983 under immediate decontrol.

I. Effects of Natural Gas Price Decontrol on Costs of Production in Corn and Wheat Farming

A. Effects on Costs

Under NGPA, the cost of natural gas embodied in a bushel of corn could rise from 11.6 cents in 1980 to nearly 14.7 cents in 1983; under accelerated decontrol, it could rise to 22.8 cents in 1983, and under full and immediate decontrol, to 23.5 cents. The cost of natural gas embodied in a bushel of wheat could rise from 10.2 cents in 1980 to 12.5 cents in 1983 under NGPA and to 19.1 cents in 1983 under accelerated decontrol and 19.2 cents in 1983 under accelerated decontrol.

These estimates are presented in Table 1. They have been obtained using U. S. Department of Energy (DOE) natural gas pricing scenarios and resulting DOE projections of natural gas prices. These prices were applied to technical gas input data furnished by The Fertilizer Institute, the American Gas Association, and the Council for Agricultural Science and Technology. Acreage and yield projections developed by Data Resources Incorporated (DRI) were employed to project effects into the future. A fuller discussion of the methodology is contained in the Appendix to this report.

Under all three natural gas pricing scenarios, the natural gas component of corn and wheat farming costs will increase, but at different rates and trajectories. Under NGPA, these costs of corn production increase at an annual rate of 8.2 percent from 1980 through 1983, or by 1.03 cents per bushel per year. Under accelerated decontrol, the annual rate of increase is calculated to be 25.3 percent; however, this increase is the result of a 63-percent surge in natural gas costs in 1982, and a 9-percent increase in 1983. Under full or immediate decontrol, the annual rate of increase in natural gas costs rises to 26.5 percent; as in the case of accelerated decontrol, this increase results from a surge in 1982 of some 82 percent. In 1983, natural gas costs embodied in a bushel of corn increase by less than one cent, or 1 percent, under immediate decontrol.

The natural gas component of the costs of wheat production follows paths similar to those of corn under the natural gas pricing scenarios. Under NGPA, the natural gas component of wheat production costs rises at an annual rate of 7.0 percent, or by 0.6 cents per bushel per year on average from 1980 through 1983. Accelerated decontrol would permit these costs to rise at an annual average rate of 23.3 percent, including a surge of 59 percent in 1982, and a subsequent change in these costs of 8.5 percent in 1983. Under immediate decontrol, natural gas costs would increase at an annual rate of 23.5 percent with a 69.4-percent surge in 1982 and a 2-percent increase in 1983.

The differences in the trajectories of costs under accelerated and immediate decontrol are due to the fact that accelerated decontrol constrains the adjustment to "free market" pricing in 1982 and leaves part of the release from control to 1983. Immediate and full decontrol removes all controls at once, allowing the price to adjust fully upon their removal.

TABLE 1: EFFECTS OF NATURAL GAS PRICE DECONTROL ON FARM PRODUCTION COSTS OF CORN AND WHEAT
(Cents per bushel)

YEAR	DIRECT ON-FARM COSTS COST OF NATURAL GAS a/		NATURAL GAS COMPONENT OF FERTILIZER COSTS		TOTAL NATURAL GAS COMPONENT OF FARM PRODUCTION COSTS	
	CORN	WHEAT	CORN	WHEAT	CORN	WHEAT
	A. Continuation of Present Policy - NGPA b/					
1980	3.5	c/	8.1	10.2	11.6	10.2
1981	4.0	c/	8.9	11.1	12.9	11.1
1982	4.4	c/	9.5	11.8	13.9	11.8
1983	4.7	c/	10.0	12.5	14.7	12.5
	B. Accelerated Decontrol in 1982 b/					
1980	3.5	c/	8.1	10.2	11.6	10.2
1981	4.0	c/	8.9	11.1	12.9	11.1
1982	6.9	c/	14.1	17.6	21.0	17.6
1983	7.6	c/	15.2	19.1	22.8	19.1
	C. Full Decontrol in 1982 b/					
1980	3.5	c/	8.1	10.2	11.6	10.2
1981	4.0	c/	8.9	11.1	12.9	11.1
1982	8.1	c/	15.1	18.8	23.2	18.8
1983	8.2	c/	15.3	19.2	23.5	19.2

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a/ Irrigation and Crop-Drying

b/ Department of Energy Scenarios

c/ Not relevant, as irrigation and crop-drying operations are not typical for wheat production on a national level.

Source: Calculated by CRS using data furnished by U. S. Department of Energy, Data Resources Incorporated, The Fertilizer Institute, and the American Gas Association.

The dominant element of rising natural gas costs in farming is in fertilizers, and, in particular, nitrogenous fertilizers. Natural gas, which is a raw material or feedstock input to the production of these fertilizers (as opposed to a processing fuel),accounts for about one-third of the cost of nitrogenous fertilizers made from ammonia, according to one estimate. 1/ Assuming fixed rates of application of fertilizer per acre 2/ and a complete passthrough of embodied natural gas costs to farmers, rising natural gas prices would have a significant effect upon fertilizer prices and, therefore, upon farming costs.

Direct, on-farm production costs 3/ due to natural gas decontrol become over time a somewhat larger share of total gas inputs in wheat and corn production. In the production of corn, they accounted for about 30 percent of total natural gas input costs per bushel in 1980, rising to 32 percent in 1983 under NGPA, 33 percent under accelerated decontrol, and 35 percent under immediate decontrol. In wheat production, direct, on-farm costs of natural gas are negligible owing to the fact that wheat acreage is normally not irrigated or further dried after harvest.

1/ Bruce Gardner, The Impact of Natural Gas Deregulation on the Farm and Food Sector (A report prepared for the Natural Gas Supply Association, 1982), p. 10.

2/ Various estimates of sensitivity to the price of fertilizer suggest that this assumption has merit. Estimates of the price elasticity of demand for nitrogenous fertilizer are low. DRI estimates that a 1 percent increase in nitrogen fertilizer prices would result in a 0.27 percent reduction in the quantity demanded. See, DRI, Agriculture Review, Summer 1981, p. 62. Also, Gardner estimated that a 1 percent increase in nitrogenous fertilizer price would result in a percentage reduction in demand in the range of 0.33 to 0.41. See, Gardner, op. cit., pp. 15 f.

3/ These costs are incurred mainly for irrigation and crop-drying. Pesticides do embody natural gas; however, according to the Council for Agricultural Science and Technology, the share of the energy component of pesticides in total energy use in farming is approximately 1 percent. See, Council Report No. 68. Energy Use in Agriculture, 1977. p.13.

The analysis assumes that about 10 percent of all acreage under corn is irrigated, and that natural gas is used as a primary fuel for pumping on about half of the irrigated acreage (54 percent). 4/ The other energy sources include: electricity (27 percent), liquified petroleum gas (9 percent), diesel (7 percent), and gasoline (4 percent). It is likely that gas would be the primary fuel only in those locations where it can be obtained at or near wellhead prices. Indeed, the U.S. Department of Agriculture reports that seven states (Texas, Kansas, Arizona, New Mexico, Nebraska, Oklahoma, and Colorado) account for 94 percent of total consumption of natural gas used for irrigation. 5/ Under these circumstances, the natural gas component of total costs would be somewhat higher than projected in these states, and lower than projected in other states.

B. The Suppliers of Natural Gas Used on Farms

The sellers of natural gas used on farms consist mainly of ammonia producers, ammonia being a major source of nitrogenous fertlizer, and of either gas producers or interstate and intrastate natural gas pipelines. The structure of these sources of supply is such that the cost of natural gas used by farmers can be determined effectively by suppliers.

Only 110 companies operating 152 plants are identified as producers of nitrogenous fertilizers in the United States by the 1977 Census of Manufacturers. The industry is characterized by a high degree of concentration, such that a small number of producers account for a significant share of the total output of the industry. The four largest, which operate 18 plants, account for nearly 34 percent of the value of total shipments of the industry. The eight

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4/ Bureau of the Census. U.S. Department of Commerce. 1978 Census of Agriculture. The percentages cited in the text do not sum to 100 owing to errors in rounding.

5/ U.S. Department of Agriculture, "Energy and U.S. Agriculture: 1974 1978," ESCS, Statistical Bulletin No. 632, April 1980.

largest companies, which operate 29 plants, account for nearly 54 percent of the value of industry shipments. Most of the companies are small; about 55 percent of the companies account for less than 2 percent of total industry shipments. 6/ This degree of concentration of production in a small number of firms implies that the largest companies have some capability to influence the price of fertilizers. In any event, industries of this nature tend to price on a basis related to costs, and prices of fertilizer are likely to reflect the decontrol of wellhead prices of the important natural gas inputs.

One analyst, Professor Gardner of the University of Maryland, notes that many of those companies are located in states in which favorable intrastate rates for natural gas can be obtained. 7/ He suggests that, under NGPA, these companies could face difficulty in obtaining future supplies of natural gas, as reserves in these states are depleted and demand of the higher priority residential sector increases. 8/ An Energy Information Administration study concludes that there is a tendency for intrastate rates to approach the levels of interstate rates for natural gas. 9/ Therefore, it is possible that the cost of the gas component of nitrogenous fertilizers could rise significantly, and, given the structure in the industry, be passed on to users of fertilizer, the farmers.

6/ U. S. Department of Commerce, Bureau of the Census. 1977 Census of Manufacturers: Concentration Ratios in Manufacturing. May, 1981, Table 8, pp. 9-90.

7/ Texas, Louisiana, and Oklahoma.

8/ Gardner, op. cit., pp. 6ff.

9/ U. S. Department of Energy. Energy Information Administration. Intrastate and Interstate Supply Markets Under the Natural Gas Policy Act. October 19, 1981. p. 27

Pipelines supplying natural gas purchased for direct, on-farm application must be expected to pass through the full increase in wellhead prices under decontrol. The pipelines constitute the only economically and technologically feasible way to transport large volumes of natural gas. While wellhead prices vary according to local circumstances of demand and supply, and prices in new contracts are "rolled in" with lower prices in old contracts to make up the regulated price to end users, the big wellhead price increases with decontrol would quickly be reflected in the users' price. The farmer consumes so little natural gas that he would have little possibility to influence prices.

II. Market Prices and Structure for Corn and Wheat, 1980 - 1983

A. Market Prices

DRI projects that corn and wheat prices paid at the farm will be rising from 1981 through 1983. These projections are presented in Table 2. If they prove to be correct, corn prices, after falling 19 percent in 1981, are expected to increase from $2.50 per bushel in 1981 to $3.09 in 1983, an annual rate of 11.2 percent. Wheat prices, which fell by 4 percent in 1981, are projected to increase from $3.88 per bushel in 1981 to $4.18 in 1983, a rise of nearly 4 percent.

B. Market Structure

The market for farm products generally is characterized by a large number of sellers. The U. S. Department of Agriculture estimated the total number of farms in the United States in 1980 to be 2.4 million, 88 percent of them having sales of less than $100,000. 10/ At least 934,000 farms produce some

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10/ U. S. Department of Agriculture, Farm Income Situation. These data were obtained from the data bases maintained by DRI.

TABLE 2: DRI PROJECTIONS OF CORN AND WHEAT PRICES PAID AT FARM
1980 - 1983
(dollars per bushel)

YEAR	CORN PRICE	WHEAT PRICE
1980	$ 3.10	$ 4.06
1981	2.50	3.88
1982	2.83	3.94
1983	3.09	4.18

Source: DRI Agriculture Review. Winter, 1981.

wheat; at least 1.5 million farms produce corn and other feedgrains. 11/

In addition to domestic producers, foreign sources of supply are substantial. DRI estimates that Canada, Australia, and Argentina will account for about 6 percent of world production of feedgrains, and the Soviet bloc countries will contribute 21 percent of total world production of these crops in 1982. 12/ With respect to wheat production, DRI projects the U. S. contribution to world supply in 1982 to be 15 percent of the total. 13/

These data are important as they demonstrate that the individual seller is so small that determination of market prices is a function of the marketplace. The single farmer is a price-taker, unable to influence the market price. The farmer cannot pass through to buyers of farm products additional costs of production resulting from changes in natural gas pricing. The farmer lacks the

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11/ U. S. Department of Agriculture data obtained by telephone, March 31,1982.

12/ DRI Agriculture Review, Winter, 1981, p. 23.

13/ Ibid., p. 30.

market power to recover the higher costs of production which can be imposed upon him by his suppliers who do have this market power. He can only hope to benefit from unforeseen factors, such as increased foreign purchases, that would boost farm prices, or from government policies that could have the same effect.

III. Effects of Natural Gas Price Decontrol on Corn and Wheat Farm Income

In 1982, accelerated natural gas price decontrol could cost corn and wheat farmers $610 million dollars in constant 1972 dollars (i.e., after adjusting for inflation). In 1983, this cost would rise to $730 million. The costs resulting from immediate decontrol would amount to $790 million in 1982 and $1.80 billion in 1983. These estimates are the difference in each year between the value of farm cash receipts less natural gas expenditures under the decontrol scenarios and the value of these net receipts under continuation of NGPA.

Under accelerated decontrol, it is estimated that net cash receipts from corn and wheat farming in 1982 net of natural gas costs would amount to $21.65 billion dollars in 1972 constant dollars. They represent 97.3 percent of the $22.26 billion in farm cash receipts from corn and wheat which would be realized under NGPA. In 1983, net cash receipts would rise to $24.67 billion, 97.1 percent of the $25.40 billion which would be realized under continuation of current NGPA policy. These dollar values of farm cash receipts, total expenditures for natural gas, and farm cash receipts less natural gas expenditures are presented in Table 3.

Under immediate decontrol, net farm cash receipts would amount to $21.47 billion in 1982, or 96.5 percent of the $22.66 billion which would be realized

TABLE 3: EFFECTS OF NATURAL GAS PRICE DECONTROL ON CORN AND WHEAT FARM CASH RECEIPTS, 1980-1983

(billions of dollars in 1972 prices)

YEAR	GROSS FARM CASH RECEIPTS	EXPENDITURES FOR NATURAL GAS a/	GROSS CASH RECEIPTS LESS NATURAL GAS EXPENDITURES
		A. CURRENT POLICY - NGPA	
1980	$ 20.83	$ 0.94	$ 19.89
1981	22.16	1.26	20.90
1982	23.49	1.23	22.26
1983	26.77	1.37	25.40
		B. ACCELERATED DECONTROL	
1980	20.83	0.94	19.89
1981	22.16	1.26	20.90
1982	23.49	1.84	21.65
1983	26.77	2.10	24.67
		C. IMMEDIATE DECONTROL	
1980	20.83	0.94	19.89
1981	22.16	1.26	20.90
1982	23.49	2.02	21.47
1983	26.77	3.17	23.60

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a/ Total production multiplied by gas cost per bushel from Table 1. Calculated by CRS using data from Table 1 and DRI Agriculture Review, Winter, 1981.

under NGPA. In 1983, these receipts would rise to $23.60 billion or 92.9 percent of the amount which would be realized under NGPA.

Farm cash receipts net of natural gas costs increase under all three scenarios but by most under NGPA. Under NGPA, net farm cash receipts from corn and wheat farming rise by 27.7 percent in the period 1980 through 1983. Under accelerated decontrol, the percentage increase is 24.0 percent; and under immediate decontrol, the percentage change is 18.7 percent.

However, under all natural gas pricing scenarios, the farmer's income position is eroded, assuming that other costs maintain their relative shares of of cash receipts. The effect of NGPA is to increase in 1983 the share of gross farm cash receipts accounted for by natural gas expenditures as compared with 1980. In 1983, these expenditures are estimated to be 5.1 percent of gross farm cash receipts in corn and wheat farming; in 1980, the share was 4.5 percent. Under both accelerated and immediate gas price decontrol, the farmer's net income position also worsens in 1983, assuming that other costs maintain their shares. The share of natural gas expenditures in gross farm receipts rises to 7.8 percent under accelerated decontrol, and to 11.8 percent under immediate decontrol.

IV. Concluding Comments

The estimates developed in this analysis clearly indicate that changing natural gas pricing policy would result in higher costs of production and, effectively, a lowering of net farm incomes. Buying inputs of natural gas in markets in which the farmer has little or no influence on input prices, and selling products in markets in which the individual farmer also has no control over price, there is little likelihood that the farmer can recover higher input costs by passing them through to consumers. Thus, the farmer's income is "squeezed" by higher natural gas prices resulting from policy changes.

APPENDIX

Methodology

I. Natural Gas Pricing Scenarios

All three scenarios are those developed by U. S. Department of Energy and published in: U. S. Department of Energy. Two-Market Analysis of Natural Gas Decontrol. Appendix A to "A Study of Alternatives to the Natural Gas Policy Act of 1978." Report No. DOE/PE-0033, November, 1981.

The NGPA scenario assumes continuation of current pricing policy in which only certain categories of natural gas would be decontrolled in 1985. It allows for partial application of incremental pricing rules, and assumes a real world oil price of $32.73 in 1980 dollars escalating at an annual rate of 3 percent.

The accelerated decontrol scenario assumes decontrol commences in 1982. Decontrol would be partial, applying only to the price categories of gas being deregulated under NGPA. There would be no incremental pricing. Oil prices are as in the NGPA scenario.

Immediate decontrol commences in 1982 and applies to all domestic gas. There is no incremental pricing.

The wellhead and industrial prices for those industries exempt from incremental pricing, including chemicals, are projected to be per thousand cubic feet (Mcf):

	1980	1981	1982	1983
NGPA				
Wellhead	1.81	2.09	2.27	2.42
Industrial	2.71	2.97	3.15	3.33
Accelerated				
Wellhead	1.81	2.09	3.56	3.92
Industrial	2.71	2.97	4.69	5.08
Immediate				
Wellhead	1.81	2.09	4.19	4.27
Industrial	2.71	2.97	5.02	5.11

II. Projections of acreage, farm product prices, and farm cash receipts

All projections of acreage, farm product prices, and farm cash receipts are those estimated by Data Resources Incorporated and published in DRI. Agriculture Review, Winter, 1981.

III. Technical Assumptions

Fertilizer application rates, obtained by telephonic communication from the Fertilizer Institute and the American Gas Association, are assumed to be 137 pounds of nitrogen per acre of corn and 58 pounds per acre of wheat. Approximately 21000 Btu's of natural gas are required per pound of nitrogen. Based on yields per acre planted, the natural gas content of a bushel of corn is approximately 0.03 Mcf and, for wheat, 0.04 Mcf. Approximately 97 percent of all corn acreage is estimated by the Fertilizer Institute to be fertilized. Approximately 70 percent of all wheat acreage is fertilized.

Nitrogenous fertilizers are used in conjunction with other types of fertilizers, and are not substitutes for them.

Inputs of natural gas in irrigation and crop-drying operations were derived from estimates of the Council on Agricultural Science and Technology, as published in its report, No. 68: Energy Use in Agriculture (1977). The volumes of gas used in these applications were derived from data in the Oak Ridge Associated Universities Report: ORAU - 160 - Industrial Energy Use Data Book.

IV. Additional Assumptions

Five percent of acreage in corn is irrigated using natural gas as a primary fuel.

Purchases of natural gas for direct farm use are made at wellhead prices.

The price of natural gas embodied in fertilizer is completely passed through to the consumer.

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The **Chairman**. Thank you very much, Senator.

In the interest of time I am going to ask members of the committee to be as brief as possible in their questions to the panel. I would remark to those Senators who have statements for the record or members of the committee who have statements for the record and who have not so far made those statements or presentations, they will be placed in the record at the appropriate place in full.

I would also caution members of the committee that we have no permission to sit beyond the conventional time of 2 hours after the Senate is in session. The Senate is to convene at 12 and that means we must terminate the hearing officially at 2 o'clock, unless unanimous consent is achieved on the floor, which does not appear to be likely.

We will have to dispense with the formal record and formal procedures of this hearing at the hour of 2 o'clock. We will continue to pursue the effort to get unanimous consent to sit beyond that time. In that context, I would also note every member of the committee has before him a list of witnesses yet to be heard and you will note that we have arranged for those witnesses in two panels.

It would be my hope that we could get to those panels relatively soon. In that spirit, I will ask that each member when called upon to limit their questions and response time on those questions to no more than 7 minutes in the initial round of questioning to the people that are here.

And may I in that respect yield my time at this time to Senator Warner.

Senator **Warner**. Thank you very much, Mr. Chairman. Again, I appreciate your holding this hearing at my request and the request of others.

At a minimum the obligation is upon us with this hearing to try and provide some explanation of what happened to create this problem of hardship to the people and what we might do to alleviate the hardship both in the lameduck session and in the future.

I hope that we do not unduly raise hopes that much can be achieved here in the lameduck session. So I phrase my question as follows: It seems to me that there are two groups, one on one end of the pipeline and one on the other. We know the people shivering who cannot pay on the consuming end, and we are here out of compassion on their behalf.

I would hope that the Federal low income assistance can be augmented very quickly to alleviate some of those hardships. Let's not raise the hopes that in this lameduck we can probably do anything legislatively, which would result in quick reaction and reduction of natural gas prices.

Now, let's look at the other end of the pipeline. We have landowners, producers, all operating within the private sector with private capital. Let's not do anything to damage their confidence and their ability to continue to invest their funds to make their land available to produce this gas.

I will start at the left with a question to my colleague Senator Danforth, let's look at the private landowners, producers. What is the likelihood of just unconstitutionally taking their property as a consequence of hasty legislation?

Senator **Danforth**. I do not believe that an abrogation of take-or-pay contracts would be held unconstitutional. In 1978, Congress provided in the 1978 act for the abrogation of certain contracts and that issue of constitutionality was litigated.

And it is my understanding that it was held to be constitutional. I have not done independent legal research on the subject, but in discussing this matter with lawyers they share the view that such a provision would not be unconstitutional.

Senator **Warner**. Do you think they will continue then to invest their capital and their land and making gas available in view of the uncertainties?

Senator **Danforth**. I think that with respect to the question of the take-or-pay contracts that these contracts really are anticompetitive. That is to say they lock in really improvident business transactions entered into between producers and pipelines.

And I do not think that anticompetitive provisions in contracts serve the interest of consumers and I also do not think that they necessarily serve the interest of producers. It seems to me that if lowercost gas is available to the pipelines, the pipelines should be able to purchase lowercost gas.

I am sure that there would be some contracts which would be voided as a result, but my guess is that what would happen would be that the producers would enter into negotiations with the pipelines and the result of that would be that they would enter into renegotiated contracts.

Senator **Warner**. I will go on down. Senator Eagleton.

Senator **Eagleton**. Basically the same answer, Senator Warner, as to the constitutional question. I would be glad to supply the committee with a legal memorandum on the point. It was pointed out the 1978 act itself abrogated contracts. That was litigated. I cannot assure the committee that there would not be litigation if this remedy were pursued. I presume there would be litigation. We are a litigious society.

As to the effect on production, I don't think either that the freeze or the cap bill on the one hand or the take-or-pay contract bill on the other hand would impact upon exploration and production.

General market conditions, general conditions of supply and recession and conservation would be more determinative in that area.

Senator **Warner**. Senator Jepsen.

Senator **Jepsen**. I have no comment on the constitutionality issue.

Senator **Warner**. Senator Kassebaum.

Senator **Kassebaum**. I do not support that particular approach. I, as a matter of fact, would have some serious troubles with legislatively negating all take-or-pay obligations and that is why I would give the authority to FERC to modify take-or-pay.

I certainly would agree very strongly with you, Senator Warner, that we should not, and it has been expressed here before, arouse constituents' hopes that they are going to see some immediate restitution of wrongs that have been perhaps addressed through these rapid escalation of natural gas prices.

But I think that there are facets that if we do enact in this lameduck session would serve consumers well and, as I say, I think enhance the production. There are many producers who are not producing. There are rigs down everywhere, because there is a great deal of uncertainty and the oversupply.

It has been questioned whether a price freeze would have any immediate effect. I understand that under sections 4 and 5 of the NGPA, there is the authority to, that FERC has the authority to order pipelines to reflect that freeze immediately. I think while it might not be much, it can be something that would at least show we are trying to address the problem.

Senator **Exon**. Your question is a good one. I want to emphasize that I think we cannot simply sit back as Members of Congress and say we must not get into these things, because the free enterprise system is at work. As I outlined the free enterprise system is not working.

There may be lots of reasons for that. The free enterprise system can only work when there are a large number of people producing or making a certain thing. That is not true and never has been true in the whole area of natural gas or oil production in general. Therefore, I simply say that it is our obligation to do what we can now to see that prices do not go any higher.

I too hesitate to get the Government into dictating in this marketplace, but the marketplace, as we understand it, the free enterprise system is not working. Now we are seeking some solutions.

The **Chairman**. I call next on Senator Johnston.

Senator **Johnston**. Thank you, Mr. Chairman. I am glad the panel is taking the attitude, to use Senator Metzenbaum's statement, that there will be no immediate restitution from this bill if passed. The idea being not to hold out any false hopes to consumers that this bill is the answer.

And to put that more in context, would you agree with, Senator Kassebaum, with the DOE study that shows, first, that the average consumer cost is $5.61 per million Btu's?

Senator **Domenici**. Is that residential?

Senator **Johnston**. Residential, that is right. That during the last year there has been a 95-cent rise in that cost. Third, that the effect of take-or-pay is 11 to 15 cents, and that the effect of NGPA wellhead price is 10 to 17 cents. When you put these two together it means this—that of the total consumer cost of natural gas you can attribute less than 5 percent to both take-or-pay and NGPA costs within the last year.

Now, do you have any information different from that or does that sound about right?

Senator **Kassebaum**. As you know, Senator Johnston, GAO and the Energy Information Administration, EIA, have different figures.

Senator **Johnston**. What are their figures?

Senator **Kassebaum**. And part of the problem that I think that we have are there are different figures to fit each of our cases. Some of the figures that I have seen, for instance, show that in 1971 wellhead costs were 16 percent of residential prices.

In 1981 that figure was 47 percent. Now this shift certainly reflects higher producer percentages and has come, I think, mostly at the expense of the distribution companies. It also reflects the need to use the higher cost gas, which at a time when we were concerned about supplies we certainly gave an emphasis to that 107 gas.

Senator **Johnston**. May I interrupt? The numbers that I just gave you are EIA numbers and as I take your answer you have no numbers different from that and I would suggest to you that no numbers exist which are different.

Senator **Kassebaum**. As far as the residential increase?

Senator **Johnston**. Yes.

Senator **Kassebaum**. The consumer increase.

Senator **Johnston**. In other words, about 5 percent of this price rise is due to take-or-pay and the NGPA price rise. The rest of it is due to a different supply mix, to LNG, to Canadian, and to replenishing of reserves.

Senator **Kassebaum**. That is right.

Senator **Johnston**. So lest we not hold out hope if this is pass about the most you could expect would be a maximum of a 5-percent price restraint to the residential consumer.

Senator **Kassebaum**. Well, I have seen a figure that says 13 percent would not be accounted for, that if only 25 percent of that 52 percent of increase is due to the ceiling price escalation and the rest due to the shifting 107 purchases, that leaves approximately 13 percent that could have been prevented, say, by a freeze.

Senator **Johnston**. That is 13 percent of the price rise?

Senator **Kassebaum**. That is right.

Senator **Johnston**. This is an enormously complicated subject and I have about three dozen questions which I will not ask because we don't have time. But to give you one simple question to show that you cannot solve this problem just overnight, in your legislation there is a proper recognition that to abrogate take-or-pay would bankrupt a lot of producers, so you therefore provide them access to the FERC in order to prove it would bankrupt them and therefore get relief.

My question is with FERC proceeding taking 2 years or more, how can you expect, when you have about 20,000 producers out there, that you are going to give them a full evidentiary hearing, no shortcut of the Administrative Procedures Act, how can you expect them to receive any real relief from FERC in light of the thousands of applications which would be filed?

Senator KASSEBAUM. I made no stipulation about the Administrative Procedures Act. I think, as a matter of fact, all I have spelled out is that FERC would be given the authority to modify take-or-pay contracts and I think—and Senator Jepsen addresses this subject as well.

Senator JOHNSTON. I believe it must be the Danforth/Eagleton bill to which I am referring.

Senator DANFORTH. If I could respond to that, it is my understanding—the provision in our bill simply states that if a producer has pledged his contract. That is if it serves as security for a loan, then FERC can modify or vitiate the provision of the bill and it is my understanding just from talking to attorneys on this that that is really a summary proceeding.

That is to say it is based on a showing of documents rather than a fullfledged evidentiary hearing. And, therefore, I think it could be done very quickly.

Senator JOHNSTON. According to the provisions of your bill it does require an evidentiary hearing. The point is that one little provision would require a full hearing and we just do not have time.

Let me ask one final question, because this clock is ticking. I am glad that you have brought this very important problem to national attention because otherwise I think the administration may have swept it under the rug for another year or two, as we did in this current Congress, but having brought it to our attention I would hope that you would not attempt to bring the matter up in this session. Would everyone agree that it cannot pass in this session? [Laughter.]

I say that because there are a lot of people with worried looks on their faces who come by my office and say are they going to pass this legislation in the lameduck and I say there is no conceivable way. I say if they have found that magic rule, I would be glad to know about it, because I have a few riders I could put on.

Well, let me assume that is a rhetorical question that does not demand an answer.

The CHAIRMAN. Senator Metzenbaum.

Senator METZENBAUM. I am going to waive my time in order to hear from gas producers and the consumer spokespersons.

The CHAIRMAN. Senator Ford.

Senator FORD. I guess I will do the same thing, but I have some yes or no questions that we might try very quickly, just say yes or no.

Do you know how natural gas prices compare with the prices of heating oil for homeowners in your State, higher or lower?

Senator **Eagleton**. Higher.

Senator **Kassebaum**. Higher.

Senator **Jepsen**. They are about the same.

Senator **Ford**. Natural gas and oil are the same in Iowa?

Senator **Jepsen**. Coming close. In fact, oil may even be coming up.

Senator **Kassebaum**. Just recently with the increase that was allowed Cities Service it is higher in most areas.

Senator **Exon**. Generally up.

Senator **Ford**. In your opinion to impose price controls on one heating fuel commodity such as natural gas and not on the other, are you being fair about it, yes or no?

Senator **Danforth**. Yes.

Senator **Exon**. Why would you want to put it on one and not the other?

Senator **Danforth**. My own view, and this is not yes or no, but my own view is that we have a full-fledged emergency on our hands now which is related to natural gas. More than half of the homes in the United States depend on natural gas for heat and in certain areas such as western Missouri and eastern Kansas, where there has been this very dramatic increase, it really is a question of survival for the individuals dependent on natural gas.

And I think Congress at certain times has to move quickly in order to meet emergency circumstances and that is fair.

Senator **Ford**. Senator Eagleton.

Senator **Eagleton**. Ditto.

Senator **Ford**. Senator Jepsen.

Senator **Jepsen**. Yes, sir.

Senator **Kassebaum**. I would agree with that.

Senator **Exon**. I would agree with that. I guess that as a witness and having sat on that side of the table for some time to ask us to answer yes or no to some of these questions puts us in a position that does not allow us to explain the total situation.

Senator **Ford**. I was just trying to shorten my time, Senator.

Senator **Exon**. I understand, Senator Ford.

Senator **Ford**. Does any of the legislation apply take-or-pay limitation provisions on all natural gas contracts, including those for imports?

Senator **Eagleton**. Speaking for the Danforth, Eagleton legislation, we do not cover the import situation and we do not attempt to cover 107 insofar as gas covered after December 2.

Senator **Ford**. Senator Jepsen.

Senator **Jepsen**. I do not address the import.

Senator **Kassebaum**. I think it is a very real concern, because the Algerian LNG and the Canadian gas has become very expensive. It is difficult for us in domestic legislation, however, to deal with foreign contracts. It would be my hope through the prudence standard in incentive rate of return that by those means the pipelines would look to renegotiating their contracts, if possible. Otherwise, we are left with foreign policy situations that make it difficult for us to have any leverage over those foreign contracts.

Senator **Ford**. You get into the Canadian problem also, I think, particularly in Minnesota. Senator Exon.

Senator **Exon**. I think your question is a good one, Senator. I simply say if we want to become energy independent as has been our goal, then I think anything we pass here has to include foreign suppliers or we do a disservice to those who we supposedly are relying on to give us some energy independence in the future.

Senator **Ford**. How would each piece of legislation, your price freeze or take-or-pay revocation be enforced? Senator Danforth?

Senator **Danforth**. How would it be enforced?

Senator **Ford**. Yes.

Senator **Danforth**. I would think that just the abrogation of a contract would really be self-enforcing. FERC could, in the case of a pipeline, which does not take advantage of the provisions of the law and therefore either renegotiate its contract or go somewhere else for lower case gas and then try to pass on that cost to the gas service company, then FERC could deny it increases in its cost that it charged the gas company.

So, ultimately, FERC would be the body which would enforce the arrangement, but I think that, as a matter of fact, you would not have to have that happen very often, because it would seem to me that if it were abrogated it would follow a course that it would be passed on.

Senator **Eagleton**. It is enforced by operation of law.

Senator **Ford**. Senator Jepsen.

Senator **Jepsen**. Senator Ford, I am glad you asked that question, because my bill does not specifically address those two and in explaining why, and what my bill does, if I could just take 2 minutes to answer your question. I have been saving up time, Mr. Chairman.

The **Chairman**. It is not your time.

Senator **Jepsen**. May I borrow some? This whole thing, the real problem is not wellhead pricing per se, it is the general pattern of pipeline gas procurement. Pipelines have entered into agreements that result in gas acquisitions often under take-or-pay contractual arrangements which have resulted in rapidly escalating purchase gas costs.

Now these are well in excess of wellhead price increases under NGPA. The problems inherent in the multitiered pricing program established by NGPA have been aggravated by contractual arrangements. That is primarily the crux of our problem. The resulting market disorder will not be resolved by freezing wellhead prices, some of which are too high and some of which are too low.

Senator **Ford**. Senator, what I am trying to find out is, the question was how would you enforce the provision in your legislation.

Senator **Jepsen**. May I finish, Senator? Rather than what is required to alleviate the current market in this is frankly to allow market forces, which are at work right now, to allow prices that are uneconomic to fall, and prices which are subeconomic to rise.

These are forces which should be allowed to operate and they will eventually stabilize gas prices. Let markets work and resolve many of the symptoms, the market disorder we suffer today.

So I think freezing prices on one hand will only frustrate the market's ongoing efforts toward resolution. Now, the other resolution on legislation proposed bans the take or pay contracts. My bill addresses this, but rather than banning take or pay in total, I propose to limit it to 70 percent of the daily volume by including this in an expanding definition of the existing fraud and abuse test, which is the key to what I propose.

My classification of the fraud and abuse criteria essentially mandates that many of the factors which have raised the cost on virtually all pipeline systems to be remedied. In doing so it works within the existing regulatory framework which has been established for years. Therefore, we could pass it immediately in this session. It presents few extra regulatory burdens.

It creates no new layer of bureaucracy. All it does is facilitate the market forces to price gas so that it can be sold. I would point out that most producers and pipelines are in business to sell gas. And unsold gas does not do anyone any good. So I think all we are doing here, I think, and hoping to do is to get some immediate action by saying to the pipeline folks and the gas folks and the producer folks that it is time to organize their business affairs in an economic way.

As Senator Boschwitz said, two people enter into a contract and change a contract. Now the contract is entered into in good faith with the circumstances at that time. The circumstances change. And they should change them——

The CHAIRMAN. Senator Ford's time has expired.

Senator FORD. I will give you the rest of my questions in writing. Mr. Chairman, I would like to insert in the record the national average fuel prices, dollar barrel equivalent.

The CHAIRMAN. It will be placed in the record.

[The document referred to follows:]

NATIONAL AVERAGE FUEL PRICES
($/Barrel Equivalent)

	OIL				NATURAL GAS		
		#6		#2			
Year	Crude Oil	Whole-sale	Retail	Avg. Resi-dntl. Price	Wellhead	Delivered to Electric Plant	Average Resi-dential Heating
1976	$10.89	$10.72	$11.49	$17.05	$3.36	$6.14	$10.73
1977	11.96	11.96	13.23	19.32	4.58	7.71	13.10
1978	12.46	11.51	12.75	20.74	5.27	8.58	15.25
1979	17.72	17.66	18.67	27.55	6.83	10.44	18.73
1980	28.07	23.14	26.09	41.08	9.22	13.22	22.91
1981	35.24	28.86	32.50	50.61	11.48	16.88	26.44
1982 (7 mos.)	32.02	26.25	29.24	49.02	13.34	19.48	30.51
				Percent Change			
77/76	+ 9.8%	+11.6%	+15.1%	+13.3%	+36.3%	+25.6%	+22.1%
78/77	+ 4.2	- 3.8	-3.8	+ 7.3	+15.1	+11.3	+16.4
79/78	+42.2	+53.4	+46.4	+32.8	+29.6	+21.7	+22.8
80/79	+58.4	+31.0	+39.7	+81.1	+35.0	+26.6	+22.3
81/80	+25.5	+24.7	+24.5	+23.2	+24.5	+27.7	+15.4
82/81	-10.0	- 9.9	-11.1	- 3.2	+16.2	+15.4	+15.4

Source: Staff, derived from data in DOE, Monthly Energy Review, November, 1982
BM:nap

Senator NICKLES. Mr. Chairman, I will follow up on that same thing. I was somewhat shocked at the answer that everyone gave that natural gas was more expensive for heating homes.

Senator EAGLETON. No; gas in the St. Louis and Kansas City markets.

Senator NICKLES. I interpreted it that gas as compared to residential fuel was higher. Anyway to resolve that, I would request staff to give us a statement, a breakdown and comparison of residential costs of gas in relationship to what it would be in fuel oil.

I asked staff for a quick breakdown and a report by the Department of Energy, the Monthly Energy Review, showed that for July 1982 fuel oil was something like $8.39 for million Btu's and natural gas was $5.59. So there was a substantial price difference with residential gas quite a bit cheaper than No. 2 heating oil; there was a substantial difference.

Evidently there is a breakdown for St. Louis. I am not sure that I could interpret it and I will not go into it at this time.

[The information follows:]

RESIDENTIAL FUEL PRICES — OCTOBER 1982
(Dollars per Million Btu)

	Natural Gas	Fuel Oil	Electricity
U.S. City Average	$ 5.96	$ 8.75	$ 21.92
Metropolitan Area			
Atlanta	$ 5.18	$ 8.31	$ 17.76
Baltimore	6.71	8.55	21.94
Boston	8.03	8.98	22.92
Chicago	4.83	8.74	23.82
Dallas-Ft. Worth	6.10	NA	21.79
Denver	6.35	NA	22.47
Kansas City	4.68	NA	18.10
Los Angeles	5.59	NA	21.39
Minneapolis-St. Paul	5.81	8.37	18.80
New York	7.71	9.05	37.01
Philadelphia	7.39	8.62	23.58
Portland	6.77	8.23	9.74
St. Louis	6.03	8.30	19.52
San Diego	7.30	NA	33.54
Washington	7.01	9.03	20.37

N/A--BLS data not available due to insufficient sample size.

SOURCE: Energy Information Administration, DOE, derived from BLS NEWS

Senator NICKLES. A couple of questions, Senator Eagleton, to follow-up on Senator Johnston's question, do you plan on introducing one or both of your bills as amendments to the gasoline tax?

Senator EAGLETON. Yes; that is our intention. We appreciate the difficult burdens that imposes. I do not deem it to be a totally futile or wasted act. If there is a will to act, then it can be resolved. In the winter of 1977 there was a will to act, because of the crisis that existed then. In our judgment a similar crisis exists now.

Senator NICKLES. Your bill calls for a price freeze and I believe Senator Kassebaum's bill also calls for a price freeze. Is this a price freeze on all gas existing in those categories with, what, the exception of 107?

Senator EAGLETON. With the exception of 107 and we draw a distinction between 107 gas discovered or produced after December 2 and then 107 gas between August 31 and December 2 to be broken down as to whether it is under contract or not.

Senator NICKLES. Let me ask you a question then. Under a price freeze, does that mean that gas prices for 107 could not decline?

Senator EAGLETON. No. Maybe freeze, and we have gotten some inquiries on this, is an inept word. I would substitute the word cap.

Senator NICKLES. Are you aware of the fact that there is quite a bit of 107 gas in our State of Oklahoma? We have seen 107 gas prices declined from, I think the price, and I will put the exact price into the record, but above $9 per thousand cubic feet and now we are looking at prices that are down to $4 and in some cases less than $4. So that is a drop of over 50 percent in a period of less than 1 year. Are you aware of that fact?

Senator EAGLETON. No. There has been some slackening of price of 107, but when you still contrast whether there is $4 or $5 or $6, and it varies from market to market. In the Hugoton field that Senator Kassebaum testified the price of gas there is 50 cents.

Senator NICKLES. Is it a fact that Hugoton gas prices are 50 cents and the price of 107 or that category of gas happens to be the only deregulated portion. So you are saying 50 cents, which is NGPA old gas?

Senator EAGLETON. Right.

Senator NICKLES. That is your 104 gas which is not a result of market factors. I have heard the market here criticized repeatedly. The discrepancy is not caused by the marketplace; it is caused by NGPA. It has nothing to do with the marketplace. In the marketplace, I looked at it, and there are 23 different pricing categories for gas; 23. That is not the market's blame. Gas is gas. Yet, we have all of these differences and people are faulting the marketplace and I think the pointing finger is at NGPA The problem is NGPA.

Senator EAGLETON. And that is the problem that the five of us here are seeking to redress. The structure of the act is such with the take-or-pay contract in existence that the expensive gas is being pushed through and the 50-cent Hugoton gas is staying in the field. The GAO report says 21,000 gas wells in Appalachian are in essence capped.

They are old wells with old gas and there they sit, because NGPA with the take-or-pay contracts in existences puts a premium on pushing through the expensive gas.

Senator NICKLES. Let me just throw out an alternative that I have here. If you did not have the market scramble that we have under the current NGPA, if you had a unified market price for gas, because gas is gas, you would not have any problem with the take or pay.

Do you advocate that we should abrogate the take-or-pay clauses in all contracts?

Senator EAGLETON. Yes. With the exception of equitable relief based on a contractual obligation with the bank.

Senator NICKLES. So we should abrogate take or pay in 104 gas?

Senator EAGLETON. We do it across the board in our bill.

Senator NICKLES. That is cheap gas.

Senator EAGLETON. 104 is cheap gas, but we go with the take or pay in all categories.

Senator NICKLES. So you will be aware of it, we have a lot of companies that are in this business that are in really financial straits. Are you aware of the fact that Amarex has filed a bankruptcy and GHK which is the leader is in deep debt in financial straits. If we passed your bill it would probably not only turn them totally into bankruptcy, one already is and another is close and we have several other major concerns that are in very, very critical financial status right now, but if we passed that bill, your bill, with those loans at banks, that you would really be driving a nail into those coffins.

Senator EAGLETON. What distress there may be out there in the natural gas industry is the distress, I think, of the current world economy. And I don't think that our legislation compounds that distress. That distress is out there. There is slack in demand, recession, conservation, et cetera.

Senator NICKLES. If your bill was passed and this kind of goes back to what Senator Johnston was saying, I am not sure there was agreement on what the effect would be. Let's say we passed both bills, both the freeze that is called for and also the elimination of the take or pay, if we passed both of those, is the consumer going to save any money?

Are we talking about giving a shot in the arm during this cold season or of how much we are going to reduce their bill in January, February, and March?

Senator DANFORTH. Senator Nickles, if I could just respond to that, I have not done a survey of every gas distribution company to find out what the results will be. I can say that we took that question to the gas service company of Kansas City with respect to the take-or-pay contracts, and the answer that the gas service company of Kansas City gave our office was that it would mean a reduction in the price of natural gas to the consumers by from 25 to 30 percent.

As I understand the question, the question has to do with the mix of gas, which is eventually sold to the consumer. And that as that mix is adjusted there can be a very, very dramatic change in the cost of natural gas to the consumers. So, therefore, if we adjust the mix so that lower cost gas is available to the distribution company and can be passed on to the consumer, the result is not 2 or 3 or 4 or 5 percent, but it can be as high as 25 to 30 percent.

Senator NICKLES. I hope, Senator Danforth, and I am trying to get some information and I know my time is short, but I was trying to give you some information and also other members of the panel of what really the effect would be if we did all of the above of the various proposals. The bills are directed at producers. We are going to freeze wellhead prices and it is going to roll back or freeze the current various categories and when you look at what the producer receive and what the transmission companies receive and also what the distribution companies receive, you will find that you are playing with a very small percentage of the pot, of that final $559 or something, the cost to the residential homeowner. That producer price you are looking at is somewhat similar to the situation in agriculture, where people said, yes, we are going to need a freeze or something on wheat or grain and we are going to save consumers on the cost of bread. I think you will find there is a very similar analogy to be made there.

The CHAIRMAN. The Senator's time has expired. Senator Wallop.

Senator WALLOP. Thank you, Mr. Chairman. Senator Eagleton, your bill goes directly to the wellhead price only.

Senator EAGLETON. That is correct.

Senator WALLOP. And only to American contracts?

Senator EAGLETON. That is correct.

Senator WALLOP. How is it possible for you or us in this Congress to go to the American producer and say to him that we are going to abrogate your contracts, but we are not going to touch the contracts of Canadians or any of those other people that supply gas; that they can continue on their contracts?

Senator EAGLETON. My answer in part is similar to that of Senator Kassebaum, realizing the short period of time in which we have to act, the least ambitious that we can be in terms of legislative scope gave us what we thought the best opportunity to act. We do not, and admittedly, do not affect the Algerian situation, the Canadian situation and what have you.

Speaking for myself and perhaps for the others as well, we would strongly urge you to address that along with the other questions raised by NGPA and the 2-year timeframe in which the freeze would be in effect.

Senator WALLOP. In the meantime we are going to go to the Americans and say we will take care of your constitutional rights in whatever way we wish, but we are going to protect those of foreigners.

Senator EAGLETON. Well, our ability to act in the time within which to act is clearly applicable on the American situation. It is less clear from a diplomatic and legal point of view on the international basis.

Senator WALLOP. Your bill provides a protection mechanism, you say for producers, that they would be permitted to show that abrogation of a particular take-or-pay clause would create a loan default or would be an unjust taking of property and presumably some type of evidentiary hearing would be required. FERC would have to make a decision on each request for relief.

Senator EAGLETON. That is correct under our bill. The Kassebaum bill is somewhat different.

Senator WALLOP. I am not sure how the protection mechanism would work. During the time it would take for such an evidentiary hearing to be held, would a producer be permitted to keep take-or-pay provisions in force or would each provision be instantly abrogated subject to being reinstated if the producer made the required showing?

Senator EAGLETON. Under our bill it would be abrogated. Under the Kassebaum bill the burden would be as you described in the second part of your question.

Senator WALLOP. It seems to me a producer has absolutely no choice but to make that case in each contract that he possesses.

Senator EAGLETON. Not all producers would be able to make that case.

Senator WALLOP. He would have no choice but to try and do it. It just seems to me that the person is disqualified.

Senator DANFORTH. I would just repeat my comment to Senator Johnston earlier. I have raised exactly the same questions with people who are much more knowledgeable in the area than I purport to be and their comment is that these really are paper cases.

That is to say that they are proved or disproved by documentary evidence. If you can show that your contract has been pledged for a loan, then you are entitled to relief. If you can't, you are not.

Senator WALLOP. If you get relief will the Government be paying interest on what they have withheld in times in the past? Who picks up that difference in price?

Senator DANFORTH. I am not sure that I understand the question.

Senator WALLOP. According to Senator Eagleton, what you said was that the abrogation is immediate. Supposing the relief comes, then how is the bank going to rely on the prospective decision of FERC if it is, in fact, a loan guarantee, if that contract is abrogated immediately and only reinstated at some future time down the road?

Will not the bank be forced necessarily to foreclose?

Senator DANFORTH. I don't think it is a future time down the road. I really think it is a question of have you pledged or have you not. If it has been pledged, then you are entitled to relief and there would be absolutely no effect on the contract whatever. And I am certain that it would be possible to set up a very summary proceeding at FERC where in a matter of minutes, if not——

Senator WALLOP. But your letter says a full hearing would be required, a full evientiary hearing.

Senator DANFORTH. No.

Senator WALLOP. Your letter, I am reading that from your letter. "A full evidentiary hearing would be required."

Senator DANFORTH. What evidence would be required though in order to prove whether or not you have pledged the contract.

Senator WALLOP. That is evidence enough that the review procedure should put to rest any constitutional questions.

Senator JOHNSTON. Would the Senator yield a minute? Actually your bill provides, and I am quoting now from lines 9 and 10, "The Commission may after notice and evidentiary hearing," and secondly it does not require a pledge at all. It requires only that it be "necessary to prevent a default by a seller under a loan agreement or debt instrument in effect on December 8, 1982."

So it requires both an evidentiary hearing with notice and cross-examination and it does not require a pledge agreement, simply that there be a debt. All of these producers have debts. So it means in each case you would have a full evidentiary hearing for virtually every producer who has take-or-pay contracts.

Senator **Danforth**. All I can do is just repeat myself. I do not believe that it is necessary to provide in this legislation that some sort of elaborate evidentiary hearing is required.

Senator **Johnston**. That is exactly what you have provided under your bill. That is your bill I was reading from.

Senator **Wallop**. I yield the rest of my time and make a comment if a gas supplier of Kansas City gas said they can reduce their consumer cost by as much as a third, I think no other consumer in the country should expect such a glorious event from their supplier, because it simply will not happen. It cannot happen, given the rest of the bill and the rest of the pricing structured under the NGPA.

The **Chairman**. Senator Melcher.

Senator **Melcher**. Under the two proposals, one being capping a price at the wellhead for the producer, is there much assurance that that would reduce anybody's gas price?

Senator **Eagleton**. It would with the retroactivity part of it that we have in the bill that makes it retroactive to August 31.

Senator **Melcher**. There is higher priced gas between August 31 and this date?

Senator **Eagleton**. Yes. The primary benefit would be of the freeze or the cap would be to protect the consumer from future increases that already are locked into law.

Senator **Melcher**. Would it be fair to say that since any cancellation of a contract dealing with take-or-pay would be litigated or would go through a long process in FERC, it would be fair to say that there is no immediate relief for any consumer.

Senator **Eagleton**. Now, that is a separate question. I took your first question as to the freeze or cap bill.

Senator **Melcher**. Yes, you answered it.

Senator **Eagleton**. On the second question, I submit there would be more immediate relief as Senator Danforth has testified by abrogating the take-or-pay contract.

Senator **Melcher**. Nothing that I have noticed at FERC ever got in the door or out of the door very fast and I wonder if this is not somewhat misleading to present this as some sort of immediate relief for consumers of natural gas?

Senator **Danforth**. Senator Melcher, I know that I have been repeating myself on this, but I just cannot believe that it is totally beyond the imagination of the Congress to devise a simple method of determining very simple factual cases.

Maybe the bill can be modified. Maybe the amendment can be modified, maybe the committee can suggest ways to modify it. But what we are getting at in the provision itself is that a modification of the abrogation by FERC should be accomplished by a very summary proceeding. Basically presenting a document should serve as sufficient basis to either modify what the abrogation accomplishes or keep the abrogation in place.

Senator **Melcher**. I do not want to belabor the point, but I think it is clear that FERC's responsibilities, as drafted by Congress, are rather complicated. And even if they were dedicated and resolved to meet each of these propositions headon and do as much as they could and as quickly as they could, working over the weekend and day and night, I doubt under your bill and under present law that that would be a very simple process for FERC.

But let's take it a step further. They have abrogated the contract. What is there that directs in your legislation for the utility company to immediately reduce the price of natural gas for their customer?

Senator **Danforth**. Are you talking about the take-or-pay?

Senator **Melcher**. What is there in the bill that would direct the utility company to immediately, forthwith reduce the price of natural gas to their customers and when would it take place? Would they have to clear it with the State? Would they have to clear a State regulatory body? Could they just like that do it?

Senator **Danforth**. This simply deals with the responsibilities of the pipeline with respect to the distribution company.

Senator **Melcher**. So whatever process there was in place by the State could cause a reduction for the gas users would then take effect. Would that be prompt?

Senator **Eagleton**. One does not have to go to the State public service commission to reduce prices. One goes to the State public service commission if one seeks a rate increase.

Senator **Melcher**. My experience with that is that it is a process set by State law and that it does take time.

Senator **Eagleton**. Not to reduce.

Senator **Melcher**. Not to reduce. They have to change all of their computers, so we allow them that much time.

Senator **Ford**. You have to go before the public service commission, I think, for a change in price. I don't remember if it is both for an increase and a decrease.

Senator **Melcher**. I think it would vary by State, but I think, again, it might be misleading here on this cold day of December to sort of be saying to the public out there that we are doing something here or we are contemplating something here that might immediately result in some relief.

Senator **Danforth**. Senator Melcher, we believe it would in very short order lead to relief. Maybe we are mistaken. I don't think we are, but maybe we are mistaken. But I guess really the question is, Are we going to try to provide relief or are we going to do nothing?

Senator **Melcher**. I want to put it in the right context for the public. Are we talking about something that we are enacting next week or this week, put into law, would it mean any relief in the January billing? I think your answer to that is probably no. In the February billing, possibly?

Senator **Danforth**. I think it would be possibly, yes, but I think that we have, it seems to me that we have a need to try.

Senator **Melcher**. That is the point I want to get to, because I think we might be misleading the public by these proposals into thinking that if the acts were just taken now, we would have some relief soon. Now, under the best of circumstances, I would think that that would be misleading the public, because I don't think much could be done very soon, regardless of how it was phrased, regardless of what mechanism we depend upon.

I just want to make one observation that goes back to what I said earlier. I think what we are really faced with is a true emergency of trying to help people who otherwise will not be able to pay their heating bill. I think that tells us that we better be looking very seriously and very quickly and positively and affirmatively at fuel assistance for those truly needy who will not be able to meet their gas heating bills without some help and I might say not just gas heating bills but for the other fuels bills too.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Melcher.

Senator Domenici, might I just hand you the gavel so you may preside while I attend to another commitment that I have to keep. I appreciate your willingness to preside.

Senator DOMENICI. Might I preside from here?

The CHAIRMAN. We will send the gavel down to you.

Senator JEPSEN. Mr. Chairman, may I ask one question before you leave? Does the National Gas Policy Act prevent contractual parties now involved in the procurement distribution of gas from changing their contracts if they want to?

The CHAIRMAN. Obviously not.

Senator BUMPERS. Mr. Chairman, if I might just inject at that point, it is my understanding that a lot of these take or pay contracts do indeed have so-called market-out provisions, if the gas is unmarketable or if the price is excessive, it is indeed renegotiable. I don't know what percentage of them have that in there, but I know a lot of those contracts are under renegotiation right now.

Senator EAGLETON. Only the more recent ones, I believe, have the market-out provision. In the essence of the Danforth-Eagleton-Kassebaum bill, it is to write a market-out provision into the ones that do not have it.

Senator DOMENICI. Might I now ask are your rules for the remaining part of this hearing Senator Bumpers if he has questions and that is the remainder——

The CHAIRMAN. Senator Murkowski.

Senator DOMENICI. Is it 5 minutes each?

The CHAIRMAN. Seven minutes.

Senator DOMENICI. And then we proceed to the next panel?

The CHAIRMAN. Yes.

Senator DOMENICI. Who is next in this sequence?

The CHAIRMAN. I think you are.

Senator DOMENICI. I thank the Chair and I will be here for a half hour or 45 minutes. I don't think I will use my 7 minutes.

First, Senators, I commend you for bringing this issue here. I would remind you that when we were writing the Natural Gas Act over months and months and months of floor action, conference, White House visits, and the like, strangely enough the issue of take or pay was there. It was there in a very different way, because of the fact that some in the United States were stuck with take or pay contracts of 22 cents that were going to run forever.

And there were those who were saying should gas remain at 22 cents, because we have a contract for as long as the well produces. Now, we are seeing this issue from the opposite end. The price of gas is too high and we want, in midstream, to abrogate contracts and change it. I commend you for your concern.

I think the conclusion that I would reach here today is that the Natural Gas Policy Act is in desperate need of reform. But I don't believe we can, without doing much like a great big balloon, squeeze it in one place, we might fix something here for a couple of months. I doubt if it will relieve people this winter, but we will see problems pop out in another place. I hope we can conclude in the next couple of days with a series of meetings between the Chair and others to arrive at a conclusion.

If as a matter of fact, if there is little relief for the consumers in reality in the next 2 or 3 months from any of your proposals or all of them, then it seems to me that we ought to proceed with some commitments as to when a bill will be produced and delivered to the floor, which would be a total reform of that act.

What really has happened is all of the calculations with reference to need on the consumer's side are out of focus. Had the demand and the shortage of supply remained as it was perceived and predicted under the act, we would not have this situation. What we would have is we would have all of the old gas and all of the new cheap gas being needed along with all of the incentive gas that was produced, and indeed it was an incentive.

Instead of being short of gas even with a heavy demand, we would have maybe had enough gas. As it turns out, the reverse happens. We have a recession and we have a cessation of the increase in the price of crude oil and demand is down immeasurably. As a result you have an inordinate impact on the equation by high priced gas.

That does not mean that there have not been some people taking advantage of it. We ought to review those too. Is there not an issue aside from take or pay as to whether or not high priced gas was bought in lieu of low priced gas, because it was good for the person who bought the high priced gas?

Is there not some question of affiliates and ownership related to the pipelines, wherein high priced gas was bought when there was cheaper gas available? For instance, this is different from area to area. While Senator Kassebaum relates to old gas being shut in, in my State 600 new gas wells are shut in. No inordinate number of old gas wells are shut in. They are for repairs, whatever that percent is, because we have many that are shut down for that. But the shut-ins are new gas in my State and not old.

I firmly believe that you have raised some very, very tough issues that ought to be resolved in the Natural Gas Act. But I would hope that we would not try to fix this very complicated issue with a couple of bandaids only to find that it did little good to anyone and it might have caused some very serious problems as we sit down and try to redress this issue.

For instance, Senator Danforth, you would like to add the word imprudently to that section in which it talks about fraud. I think we could find a number of situations, you and I, trying as we would, would, have a very difficult time determining what was prudent and what was not. Was it imprudent for the first 16 months of the Natural Gas Act when supply was very short for people to enter into long take-or-pay contracts at a high price?

Did it get more prudent or imprudent as supply increased? I do not know, but certainly in the early days of the act nobody that had deregulated gas would get a good contract on it. Who was prudent and imprudent, does that change over time? It just appears to me in the interest of getting the business of the Senate done that if we could arrive at some facts will there really be a significant impact on the down side in the next 3 or 4 months for the consumers of this country or not? If it is doubtful it seems we ought to work out something other than to tie up the work of the Senate and believe me it will be tied up on any bills, the gas tax bill or the continuing resolution in this kind of cure, which there will be plenty of evidence, will do nothing if nothing significant is offered.

That study that you referred to, Senator Eagleton, of the General Accounting Office gives us one problem we did not even address. Their conclusion on page 3 says that there was one place in California where after stating the reasons for prices going up, there was a new price schedule being promulgated to raise the residential 70 percent and commercial 30, because the commercial is going off of natural gas and they would like very much for them to pick up the excess that they have got.

If that is the case in very many parts of the country that might account for much of the increase, aside from any issue we have described here, and then one might say are they right.

I don't have any questions. Obviously I have participated in this issue for a long time. It is very complicated and did not turn out as we had planned. On the other hand, it might not turn out as we have planned if we do something of the type being suggested here. It might turn out to have a very adverse effect over a long period of time, while we might be able to make some repairs of this very complicated act, that has some long-term effects of keeping the supply up and keeping the prices down.

There is no question it is out of kilter. With heavy supply excesses, the prices should not be going up inordinately. I don't think there is any question about that. People are stuck in those traditions, some innocently and perhaps as we investigate it, perhaps some not so innocently. But I would certainly hope that we would try to work this out where we can get started on it in January and get a real fix rather than the fix as proposed here. And I say that in all deference to your genuine concern and the great amount of work and effort that you have spent on it.

With that, I will yield to Senator Murkowski.

Senator MURKOWSKI. Thank you, Senator Domenici. I certainly want to thank my colleagues for bringing this matter up before this committee. Although we can all question our ability to resolve the gas pricing problems during the time remaining in this Congress, I think you are representing your individual constituencies in a very responsible manner. I think you have presented not only to the committee, but certainly to the industry a challenge to solve the pricing dilemma.

That challenge is a substantial one, and I look forward to the industry responding rather than relying on the dictates of Government to come up with a solution.

I am told that there are approximately 19 billion cubic feet of gas being utilized in this country daily; of that 19 billion cubic feet, 10 are low-cost gas. The amount that is shut in specifically due to take or pay is approximately 1 billion cubic feet.

I wonder if anyone does not agree with this statement: The depletion of low-cost gas reserves is the primary cause of the fact that there is more high cost gas being rolled in.

Senator **Eagleton**. That is certainly not true with respect to the City Service that supplies Gas Service Co. in Kansas City. They would dispute that, because their principal source of low cost gas, the Hugoton field is being only used to a small extent and the reason they are pushing through the high priced gas, they attribute that to the take-or-pay contract.

Senator **Murkowski**. The figures I have given you are aggregate figures. If you recognize those as being correct, the 1 billion cubic feet of gas being shut in due to take-or-pay is relatively small in the overall scheme.

Senator **Eagleton**. But the take-or-pay provision skewes the end result. It may be a small percentage nationwide of gas that is being shipped, but because of the nature of the contract it skewes the result where, and Senator Domenici points out, we have a glut of gas we have these prices going through the roof.

Senator **Murkowski**. Don't you feel that that could be addressed in reexamination of the NGPA? I am looking at the overall picture. The mix that we are concerned about here is relatively insignificant currently.

Senator **Eagleton**. I would be somewhat comforted if I were certain that this committee and the Congress would meaningfully address the inequities or the imperfections of the NGPA next year, considering the anguish and the time consumed when it was originally enacted. I am not certain that that is going to occur and, thus, what we are trying to do here, albeit in a limited way, and in a targeted way, is try to address some specific problems that we are facing this winter.

Senator **Murkowski**. I would certainly concur with that. I think the testimony brought out here certainly showed exceptions. But I am relating to the realities of what the arithmetic is in the mix today and it does appear that it is rather insignificant in relation to the total. And I am wondering why we cannot revisit the NGPA to respond to the incidental specific cases where there are gross adjustments where there is no question about it.

Senator **Danforth**. Senator, I have two comments to make. First of all with respect to the take-or-pay contracts, it varies widely from area to area. In the eastern part of Missouri, it is my understanding that it is a very small part of the problem. In the western part of Missouri, it is a very large part of the problem,

And I guess it is somewhat like saying, well, if the American shoe industry hits a decline that is a very small percentage of the total number of jobs. But for those communities with a shoe plant, it is a very, very large part.

And, second, I accept everything that has been said about the need to proceed on complicated matters in an orderly fashion, to hold hearings, to get on with it, and I am sorry we have not done this before, but I think really the question is if we put off to a later day the more leisurely way of proceeding with legislation, what happens this winter.

I don't get any great delight in trying to do something right now that will, as I say, gum up the works in the Senate, now on the 13th of September, when we are supposed to be trying to get out on the 17th. Everybody knows we will not. But I have no delight in trying to gum up the works now and I want to pass a gasoline tax bill and I want to pass a continuing resolution and I want to do so as responsibly as possible.

But if the Senator can suggest some immediate relief for these people who are suffering right now, which is clearly stop gap, clearly of an emergency nature, and target it as carefully as you want it to be, but to provide at least some emergency relief that we can agree on and then take up the larger problems at some later date, I for one would be most willing to cooperate with you or anyone else in trying to fashion such an approach.

I do not see one right now. But I do say is I just do not think that we on this panel, whose constituents are suffering now can simply say, oh well, fine, let's just wait until next year or the year after and maybe we can accomplish something.

Senator **Murkowski**. I appreciate that. I think there is a lack of general agreement on the possibility of emergency relief, even coming out of this lameduck session. I think though that we are in agreement that it is a national problem and certainly we are in agreement that the depletion of low-cost gas reserves is the primary cause of high-cost gas being rolled in. There is no question about that.

The question is how do we address exceptions if, in fact, we recognize that shut-in gas due to take or pay is relatively small compared to the whole.

I think my time is up, Mr. Chairman.

Senator **Domenici** [presiding]. Thank you. Senator Bumpers.

Senator **Bumpers**. First of all, Senator Johnston raised the question of whether or not there is a bill that has any realistic chance of passing during this lameduck session and I think all of us, to be candid, would have to admit, not one is going to pass, but I want to thank all of the authors of the various proposals for your sensitivity to a very difficult and complicated issue and one that must be addressed to the Congress.

I saw a DOE study in 1979 that showed the average, median income family in this country, let me go back in 1973 the average, median income family in this country was spending 7 percent of its disposable income for energy. And in 1979 that figure was 22 percent. As I look over the charts, handed to the members by the staff, you can see that natural gas prices per thousand cubic feet per million Btu's has gone up 60 percent since that study was done.

There is not any question that a lot of middle income and lower middle income people in this country are being devastated and we can do something about it or we can say it is too complex to do anything about.

One of the questions I wanted to ask any of you, and it sort of follows up on what Senator Murkowski was pursuing, according to the statistics I have seen we used 20 trillion cubic feet last year, in 1981. Projections are that we are going to use about 18.5 trillion cubic feet this year in 1982. And even despite the decreased consumption prices keep going up.

And we are talking about one of the culprits being take-or-pay contracts. My question is how much of that gas as a percentage is take or pay, if you know?

Senator **Kassebaum**. There are various figures on that, Senator Bumpers. It can be as high, they estimate, as 80 percent.

Senator **Bumpers**. Eight percent?

Senator **Kassebaum**. Eighty. But that, again, varies, of course, in different parts of the country.

Senator **Bumpers**. When you look at the charts here, you see some regions are really devastated, while others are not hurt quite so badly. But to suggest that take-or-pay contracts are sacrosanct and neither the Congress nor FERC ought to abrogate those, I know that an awful lot of those contracts have what are called market-out provisions. And that is they are renegotiable, if the pipeline company says that we cannot market this gas at the price you are proposing to charge us under NGPA.

And if that is true, it would be my assumption further that when these people took these take-or-pay contracts to the bank and borrowed money on them, the bank does not loan, nor could the producer commit the total proceeds on the asssumption that he is going to receive the maximum price available each year as the price is allowed to rise.

And if the bankers have not done that, it does not look to me like all of the producers who have signed the take-or-pay contracts are going to go bust. I would like to look at some typical take-or-pay contracts and see what possible relief there is in there for the pipeline companies.

Senator **Eagleton**. I think if you inquire of the next panel of witnesses, the consumers or the producers, but it is my understanding that market-out provision is in some of the more recent agreements, but that the original take-or-pay agreements, dating back to the inception of the Act did not have a market-out provision in there. Now, that is my understanding.

Senator **Bumpers**. It is my understanding also that the earlier contracts did not have that in them. Let me ask you one other question, if anybody knows. There is a GAO study, which I have not read, that touches on, and that is, what if we were to abrogate all take-or-pay contracts and deregulate natural gas totally, what is the projected effect on the price? Does anybody know?

Does anybody know how much gas is shut in other than the 21,000 wells in Appalachia that Senator Eagleton alluded to?

Senator **Eagleton**. I don't have that figure.

Senator **Bumpers**. Thank you, Mr. Chairman.

Senator **Domenici**. Thank you very much, Senator Bumpers.

Senator **Eagleton**. By the way it is a figure such as that it is the last provision in our freeze bill which would ask the General Accounting Office to make a statistical analysis of what the consequences would be.

Senator **Bumpers**. One other point, Mr. Chairman, I have got about 60 seconds left. I had always resisted decontrol of oil prices simply because oil prices are not determined by free market forces in this country. They have always been set by the cartel and I did not think we ought to condone that or accede in it as though it were a legitimate thing the cartel did by acquiescing in it and deregulating and letting the cartel determine what oil was worth in this country also.

I recognize that there are two schools of thought on that and I found that out, and the other school prevails. But I would also like to say that the amount of gas we import is minimal, and, therefore, I don't think, while I would like to see heating oil prices down and I recognize that the gas prices at this point are not as high on a Btu equivalency as heating oil prices are, they are going to exceed heating oil prices at the rate they are going.

We have another 60-percent increase over the next 3 years. I am not suggesting we roll prices back. I think that is probably not at all possible. What we are trying to do is make sure we do not go through another devastating series of price increases over the next 3 years. The country cannot afford it.

Senator **Domenici**. Senator Ford, did you have any additional questions?

Senator **Ford**. I wrote down a question earlier on. The six Senators we have had here today are as sincere about solving this problem as any group I have ever talked to in my life. What really is disheartening I think or disconcerting is that there is no way apparently that we can arrive at, particularly the Eagleton, Danforth, Kassebaum legislation, put that together and arrive at some kind of an immediate solution that would satisfy the majority without getting into reinstating price controls other than the cap or in the deregulation of price.

I wish there were some way we could put it together, because it is needed, and I think it is the right thing to do. I have been listening, and reading the statements and the questions and answers of those in the gas industry, in many publications, and they sense the problem that is here. And I think if we did not get into that fight again, we could probably solve some of the problems. If you could arrive at that, I think you could get it out of here in 5 minutes.

My sense is that those who want to keep the price up are not going to let us. It is not in the cards. I wish it were.

Senator **Domenici**. Senator Exon.

Senator **Exon**. Mr. Chairman, some of the questions that have been asked me today, I assume that those on that side of the table assumed I was a sponsor of one of these bills; I am not. I am here seeking information. I asked to sit up there, but the staff said I would be better off down here.

It seems to me in listening to this that we are not going to get anything done in this special session. Therefore, it seems to me, as I indicated to this committee when I was here 1 year ago, we are just not moving fast enough on this.

I would suggest then at this time that you as acting chairman accept a sense of the Senate resolution that I had prepared as possibly something that we could all agree on, that is designed primarily to say that we are going to have to make some changes in this area. What they are going to be no one knows.

But at a minimum it would be designed to put pressure on gas companies, the producers and the transporters of natural gas to get busy in their own right with the clear understanding that unless they can do something to alleviate the situation that has been well articulated here this morning, that the Congress is going to have to move and I submit that to the committee.

Senator DOMENICI. We would be pleased to accept it, Senator. Obviously it is up to others on this committee and even the chairman, if he were here. We would be glad to accept it.

On behalf of the committee, I thank the Senators, not only for their promptness this morning but for their patience.

[Whereupon, there was a recess.]

[The resolution submitted by Senator Exon follows:]

97th CONGRESS
2d Session

S. Res.______

IN THE SENATE OF THE UNITED STATES

Mr. XXXX submitted the following resolution; which was ______________________________.

RESOLUTION

Relating to the need for the natural gas industry to reform contracting practices so as to obviate the need for Federal legislation in this area.

WHEREAS, the Natural Gas Policy Act of 1978 has succeeded in its basic purpose of encouraging the development of domestic natural gas supplies; and

WHEREAS, delivered natural gas prices in many areas of the country have already increased to levels competitive with the price of alternate fuels; and

WHEREAS, many existing long-term natural gas purchase contracts between producers and pipelines were entered during a period of supply shortage and need to be renegotiated; and

WHEREAS, many such contracts contain provisions which allow increases in wellhead gas prices, but do not allow decreases; and

WHEREAS, such contractual commitments prevent the price of natural gas from increasing or decreasing as appropriate to reflect market conditions; and

WHEREAS, both the Senate and the House of Representatives have, through extensive hearings, focused gas industry attention on the problem of supply-demand imbalance in the gas industry; and

WHEREAS, not all pipelines and producers have responded to a changing natural gas market and initiated efforts to renegotiate contract provisions to be more responsive to actual market conditions; and

WHEREAS, those pipelines and producers which have initiated efforts to renegotiate contract provisions to be more responsive to actual market conditions should be encouraged to continue their efforts; and

WHEREAS, gas producers and pipelines may be able to effect a demand-supply balance through such renegotiations and thus avoid the need for Congress to legislate in this area: Now, therefore, be it

RESOLVED, that it is the sense of the Senate that natural gas producers and natural gas pipelines should be encouraged to recognize that delivered prices for natural gas are already competitive with the price of alternate fuels in many regions, and to renegotiate producer-pipeline contracts to respond to changing market conditions in order to provide an orderly transition to a deregulated market; and

BE IT FURTHER RESOLVED, that it is the sense of the Senate that unless such renegotiation takes place in a timely fashion, the Congress should take such steps as may be necessary to resolve the impasse over contracts in order to protect natural gas consumers from unwarranted price increases, and to provide for an orderly transition to a deregulated natural gas market.

Senator **Domenici**. Why don't we start with the general suggestion to you that you make your statements as brief as possible, because we cannot sit beyond 2 p.m., and we will insert your full statement in the record and let's just leave it up to the Chair here and if he gets too long winded, we will ask you to cut it short.

We will start then with Nick Bush, president of the Natural Gas Supply Association.

STATEMENT OF NICHOLAS J. BUSH, PRESIDENT, NATURAL GAS SUPPLY ASSOCIATION

Mr. **Bush**. Mr. Chairman, I am Nicholas J. Bush, president of the Natural Gas Supply Association. NGSA represents producers and markets about 90 percent of the domestic supply of natural gas sold in the United States. We do not represent pipelines or distribution utilities.

Before getting in, Mr. Chairman, I would ask that my complete statement and its attachments be entered into the record and I will keep my remarks brief.

Senator **Domenici**. It will be made a part of the record.

Mr. **Bush**. Mr. Chairman, before getting into my remarks, I would like to clear up at least two points that I think are worth commenting on with regard to the prior testimony. I think Senator Ford has probably entered into the record a document which might clarify this, but I think it bears mentioning that according to the Bureau of Labor Statistics for October 1982, the residential price of natural gas varies from $4.52 a million Btu's to $8.02 a million Btu's. And the price of heating oil varies from $8.22 per million Btu's to $9.23 per million Btu's.

Nowhere in any region does the price of natural gas equal or exceed the price of heating oil and I think it is interesting to note also that among the lowest prices in the country are in Kansas City and the prices in St. Louis are about average. We agree with you, Senator, and, Senator McClure, and Senator Jackson, and Johnston and other members of this committee who recently urged the Senate to oppose any piecemeal gas legislation during the post-election session.

We simply do not take this position, because we are not sympathetic to those suffering from the effects of trying to work out from under more than 30 years of wellhead price controls and from the distortions and inequities caused by the Natural Gas Policy Act. Far from it, we along with many, many others have tried unsuccessfully for more than a year to convince Congress to address the natural gas issue in a comprehensive fashion.

The piecemeal legislation now being posed, however, will not bring speedy relief. In fact, most of the proposals would not bring any relief, only further prolonged inequities. Recent comments by a number of people suggest rising natural gas prices is the result of decontrol and attributable only to producers.

As members of this committee I now realize, about 90 percent of all the domestic natural gas is price controlled at the wellhead. Unfortunately many consumers do not realize this. Furthermore, about half of this production will still be controlled following partial NGPA deregulation in 1985. This large amount of forever regulated gas combined with numerous other failings of the Natural Gas Policy Act creates havoc for producers, transporters, distributors and users.

Consumers, unfortunately, are the ultimate victims of the distortion. The largest consumers of gas, industrial users, are urging a phased, total decontrol of natural gas and an end to restrictions on its use as a cure for these problems. Other consumers, however, namely residential users, are being encouraged by some to focus the blame for these distortions upon natural gas producers and they are being urged to write their Congressmen seeking a freeze on wellhead prices and significant Federal intervention in natural gas contracts.

It seems imperative to us, therefore, that there be some understanding by policymakers as to what is happening to the natural gas prices and what role the wellhead is playing in these increases. If one analyzes the increases that have occurred in residential prices, one will find that about 50 cents of each dollar of increase took place at the wellhead and the 50 cents went to increased costs in transportation, local distribution, costly gas supplements, such as SNG, LNG and pipeline imports from Canada and Mexico.

This proportion is true if one looks back 1 year or 10 years. The fact that the average wellhead price has increased is not surprising. That is public policy. What is more, we think it is a good policy, since it is only the increase in wellhead prices from the absurdly low levels of the early 1970's that have stimulated domestic drilling and retarded the precipitous drop in crude reserves experienced during the last decade.

It is clear that the two are linked. During the decade of the 1970's, average wellhead prices increased from 17 cents to $1.50. At the same time gas drilling expenditures went from $617 million to $8.5 billion, a 12-fold increase. We believe, in other words, that consumers have gotten their money's worth for the dollars they have spent in higher wellhead prices.

I also believe it deserves mention, and I realize again that it will not win residential gas users over, but the fact is that natural gas is still a bargain for the typical residential user. It still represents only two-thirds of the price of heating oil and about one-fourth that of electricity on an energy content basis. Whether or not it will remain a bargain fuel will depend, I think, upon whether or not the distortions that are now driving some industrial users for whom alternate fuels are most competitive from this market are corrected by comprehensive legislation next year. To attempt band-aid solutions, however, such as those presented to this committee, we believe would be a serious mistake for all.

I believe there has been enough said about freezing current wellhead prices. Let me just offer the observation that in some of the legislation now suggested a 2-year wellhead price freeze and a 2-year delay of the partial decontrol scheduled under current law for 1985 would result in a significant loss of domestically produced natural gas.

This lost production, we calculate, to amount to 17 trillion cubic feet over the period of 1983 through 1981. That is based on estimates using an analytical model, which I described in my testimony before the House subcommittee last September and which is part of one of the attachments to our statement.

This would equate to a loss of 2.9 billion barrels of oil on an energy equivalent content basis and would have to be replaced necessarily with additional imports worth over $90 billion at current prices. Some small temporary relief for natural gas consumers, thus, directly would lead to increased OPEC imports and higher prices for all consumers who use heating oil, motor gasoline and other refined products.

Considerable attention has been given as well to calls for Federal intervention to private contracts, with some suggesting outright abrogation of certain contractual clauses. The suggestion heard most often is the so-called take-or-pay clauses in current contracts which exceed some arbitrary standard should be capped at some lower level or simply outlawed altogether.

Mr. Chairman, few issues in the natural gas industry have been more distorted than the understanding of take-or-pay clauses. The take-or-pay provision is designed to meet the needs of both the producer and the pipeline. It provides the buyer to take a minimum quantity of gas on a daily, monthly or an annual basis, but if he does not take this quantity of gas, he must pay the producer as if he had taken it.

This does not mean that the pipeline pays more money for less gas. The reason is that a pipeline has the right to make up the deficiencies it intakes, either at no cost or by a payment of a small price differential, if the price of the gas has increased between the time that the payment is made and the time the gas is taken into the system.

We can all speculate on what the gas industry might be like without take-or-pay provisions, since take or pay is a tradeoff for long term commitments, producer pipeline contracts would be significantly of shorter duration. Surely there would be a major change in pipeline financing requiring more equity participation and—in order to cut this shorter on take or pay, I would like to move on, if I could, Mr. Chairman. We simply believe that abrogation of take-or-pay clauses would not reduce gas bills significantly but would undoubtedly be a serious concern for producers, investors and the financial community who see these clauses as the underpaying of existing financial commitments.

Another suggestion, which I think bears mentioning, is the amendment that would lead to so-called directly purchased least cost mix for pipeline. I would be happy to answer specific questions about problems with this approach, but suffice it to say that such an idea would have a worst possible immediate ramification among producers, the financial community and we believe on the supply of domestic natural gas available.

Mr. Chairman, legislation and regulations generally do a poor job of transmitting market signals. Given all of the restraints and impediments of the current NGPA, the natural market forces are still transmitting signals between various sectors of the gas industry. The just released report of the General Accounting Office, which was earlier entered into the record, concludes on page 33, 'There is a growing body of evidence that the natural gas market is acting to reduce prices and otherwise adjust current excess supply."

Market signals would be more effectively transmitted with reduced regulation, not by adding additional regulations through these piecemeal legislative proposals. It is highly unlikely that any of the piecemeal proposals which have been surfaced will yield the results which their authors intend: Immediate price relief for residential gas consumers.

It is very likely that they will lead to adverse consequences for all consumers of natural gas and other sources of energy. A comprehensive well-reasoned approach to the entire natural gas issue from the wellhead to the burner is required.

Thank you, Mr. Chairman.

[The prepared statement and attachments of Mr. Bush follow:]

STATEMENT OF THE NATURAL GAS SUPPLY ASSOCIATION

BY NICHOLAS J. BUSH, PRESIDENT

BEFORE THE SENATE COMMITTEE ON ENERGY AND NATURAL RESOURCES

DECEMBER 13, 1982

My name is Nicholas J. Bush. I am President of the Natural Gas Supply Association, an organization of producers who market about 90 percent of the nation's gas.

The Association thanks the Chairman and his staff for affording us the opportunity to participate in today's hearings to examine the state of current natural gas markets and to consider whether short-term emergency measures are appropriate in the last days of the 97th Congress.

NGSA recognizes that there is a need to find a workable solution to the natural gas problems facing the nation. We also recognize the serious and legitimate concerns on the part of many members of the Congress that have prompted them to propose immediate relief for residential consumers.

We believe that enactment of piecemeal solutions to this most complex problem, even for a short time, could result in more, not less, damage to the nation's consumers and to the industry that has been built to supply them with this commodity.

The natural gas issue presents complex problems affecting pipeline companies, distribution companies, large, middle-sized and small producers, The Federal Regulatory Commission, state regulatory commissions, industrial users as well as residential consumers. The present law was enacted after months and months of consideration of the many aspects of this complex puzzle.

Before commenting on the proposed legislative solutions and to save time, I should point out that I testified last September before the Subcommittee on Fossil and Synthetic Fuels of the House Committee on Energy and Commerce on the Natural Gas Policy Act of 1978. At that time, I pointed out the shortcomings of the NGPA in responding to supply and demand for natural gas. I noted the inadequacy of the NGPA in addressing our long-term supply problems, and noted the significant distortions in the allocation of drilling capital as well as the irrational economic incentives for the entire industry created by the current law. That testimony stressed, however, that piecemeal solutions alone would not solve the problems with the NGPA. In fact such action would only create further problems for producers, pipelines and eventually the customers they serve.

Mr. Chairman, rather than repeat those remarks I would like to request that my complete testimony presented before the House subcommittee be included as part of my testimony before this Committee today.

Piecemeal Legislation is not the Solution

Legislation has been introduced which attempts to solve the problems in the industry by either imposing a price freeze at the wellhead, or abrogating or restricting the operation of existing contract provisions between the parties so that a pipeline will be required to take the least expensive gas under contract to it, without incurring any financial penalty.

None of the "quick-fix" legislation which has been proposed will resolve the distortions which already exist in our gas markets - distortions which are a direct result of excessive and counterproductive regulations. For example, the wellhead price established for more than 25 categories of gas varies as much as 3,500%. Because pipelines have access to varying supply components, some may pay an average price for domestic natural gas more than twice as much as some other pipelines (according to the September 1982 EIA study).

Piecemeal legislation such as the wellhead price freeze proposal would institutionalize these present distortions, which are leading to very high prices for some consumers while creating low, subsidized prices for others. Price controls create excess demand, retard supply development, and lead to shortages.

As this committee is well aware, legislation and regulations generally do a poor job of transmitting market signals. Given all of the restraints and impediments of the current NGPA, the natural market forces are still transmitting signals between various sectors of the gas industry. The GAO in its December 1982 report concludes that "there is a growing body of evidence that the natural gas market is acting to reduce prices and otherwise adjust to current excess supply." Market signals would be more effectively transmitted with reduced regulation, not by adding additional regulations through these piecemeal legislative proposals.

It is highly unlikely that any of the piecemeal proposals which have surfaced will yield the results which their authors intend - immediate price relief for residential gas consumers. It is very likely that they will lead to intermediate-term and long-term adverse consequences for all consumers of natural gas and other forms of energy. A comprehensive, well-reasoned approach to the entire natural gas issue - from wellhead to burner-tip - is required. The "quick-fix," piecemeal approach will do more harm than good.

Wellhead price freeze legislation is counterproductive

First, as to the price freeze legislative proposals. Although these proposals represent an effort to hold down consumer price increases, we believe that these proposals will, in fact, have no effect on the factors which have caused 82% to 90% of consumer price increases. In fact, the effect of a price freeze at the wellhead would aggravate some of these other more significant factors within a few years.

According to the most recent DOE data, average residential gas prices rose by $.95/MMBTU between July 1981 and July 1982. Of the $.95 increase, only 39¢ was attributable to increased domestic producer revenues. The other 56¢ was the result of increases in pipeline and distribution costs, and the costs of imported natural gas and LNG. Thus, over one-half of the residential price increases are not associated with increased producer revenues. (Monthly Energy Review, DOE/EI-0035 (82/11) November 1982.)

According to DOE studies of interstate pipeline costs, only 25% to 44% of the increase in producer revenues is attributable to increases in gas prices under the NGPA monthly escalations. Thus, of the 39¢ in additional revenues received by producers, only 10¢ of 17¢ would have been affected by a wellhead price freeze. (An Analysis of NGPA Interstate Pipeline Wellhead Purchases - An Analysis of the Natural Gas Policy Act and Several Alternatives, Part III. Energy Information Administration, U.S. Department of Energy, September 1982, (DOE/EIA - 0357.)

The additional 56% to 75% of the increase in producer revenues, according to the DOE studies, is caused by changes in the mix of gas taken by pipelines. For example, gas from old wells is priced much lower than the incentive prices afforded new wells. As old wells are depleted, pipelines must replace these cheaper gas supplies with higher-priced gas from new wells. A portion of the increase may also be attributable to the gas supply management practices of pipelines. This portion of the increase in producer revenues, however, would not be affected by a price freeze on the various categories of gas.

In short, if the price freeze proposals had been enacted in 1981, only 10¢ to 17¢ of the 95¢ increase experienced last year by residential users would have been eliminated.

The bulk of the increase in residential energy costs, 56¢ of the 95¢ increase last year, is accounted for by the following factors.

More than half of the average residential gas bill consists of fixed transportation and distribution charges (such as the amortized costs of building the pipeline). Consumers must pay these fixed costs regardless of the actual volume of sales by the pipeline. Obviously, the more gas the system sells the lower the unit costs of transportation. This is because the fixed costs are spread over a greater volume of gas. In the past 18 months, pipelines and distribution companies have experienced substantial industrial load loss caused by the economic slow-down. The fixed costs previously carried by these industrial customers have been spread over the remaining customer base, causing unit gas prices to increase.

Imports of Canadian and Mexican gas, Algerian LNG and SNG also are included in the 56¢ of the gas price increases not attributable to domestic producers. While domestic wellhead gas prices average $2.40/MMBTU, Canadian gas costs $4.94/MMBTU and LNG, $7.16. Of course, a federally imposed price freeze would not affect the contribution of these prices to the delivered price of natural gas.

Although increases in wellhead price are responsible for only a small fraction of the rate increases now faced by some users of gas, I do want to emphasize that these changes in the average wellhead price of gas are to be expected and are consistent with our national policy for this commodity. Again, according to DOE statistics, last year domestically produced natural gas at the wellhead sold on the average at an oil equivalent price of less than 30¢/gallon. By any measure, this was far below the true commodity value of this clean burning fuel. Therefore, it should come as no surprise to find that, as permitted by law, the average price of gas in the field continues to increase. This is the unavoidable consequence of having for so long (almost 30 years) regulated the price of natural gas at levels far below its true worth. The inevitable adjustment to the laws of supply and demand will be made only more difficult if delayed by temporary "price freeze" legislation. This is the age-old story of price controls. Ultimately they fail, and do far more mischief over the long-run than their temporary, short-run effects can ever justify.

Furthermore, despite the price increases which are being reported, natural gas remains a bargain for the typical residential consumer. The DOE reports that the delivered cost of natural gas to the average residence is only 2/3 that of heating oil, and 1/4 that of electricity, on an equivalent energy content basis. To hold down by government edict the price of natural gas at the wellhead is to repeat the folly of the Natural Gas Act - the bankrupt policy which directly led to the massive curtailments, hook-up moratoria, shortages, and plant closings of the mid-1970's.

In our judgment a wellhead price freeze through 1985 will have severe adverse consequences on supply and will perpetuate and aggravate current market disorders. The most serious consequence of a price freeze will be its impact on the intermediate and long term supplies available for the consumers 3-5 years (and longer) from now. Gas reserves are continuing to be consumed at a rate of 18 - 19 Tcf per year. These must be replaced by newly discovered reserves if production is to be maintained at the same levels. New discoveries have lagged behind annual consumption for more than a decade, so we are depleting our stock of proved reserves. The inventory of proved gas reserves in the lower forty-eight states declined by 124 Tcf or 43% between 1967-1980. Only the inclusion of positive revisions and corrections made possible a slight gain in reported reserves last year.

Current gas exploration and development programs are based on the prices set out in the NGPA, coupled with the expectation of decontrol of new gas in January 1985. If those expectations are destroyed, exploration and development programs will be sharply reduced. Because many exploration and development programs require years to fully implement, these reductions will not impact on production until 1 to 5 years in the future. Many pipelines are already predicting shortages in this time period under current conditions. The large "inventory" of proved gas reserves this country had in the 1960's has been used up, even though the potential for new discoveries remains large. Depletion rates in new fields are much more rapid. Therefore the current "oversupply" will disappear quickly. Our policies must continue to encourage gas exploration and development. Legislation that discourages gas drilling now is bound to have serious repercussions in the mid to late 1980's.

The current supply excess is primarily a function of reduced demand, which could change quickly as the economy recovers. A wellhead gas price freeze means falling real prices. Drilling rates in 1982 have already dropped by 40%. A decline in real prices would further reduce drilling and could quickly result in gas shortages.

A reduction in domestic gas supplies will increase consumer energy prices. Faced with declining domestic supplies, gas pipelines will have to obtain new supplies from foreign sources. Currently such sources offer gas prices at 50% to 100% above new U.S. gas supplies. To the extent available supplies can't meet market demand, imported oil will be substituted. The increased demand for imports will put upward pressure on oil prices.

We expect that legislation of the type some are proposing - a two-year wellhead price freeze and a two-year delay of the partial decontrol scheduled under current law for 1985 - would result in a very significant loss of domestically produced natural gas. This lost production amounts to 17 Tcf over the period 1983-91, based on estimates using an analytical model which I described in my testimony before the House Subcommittee last September. This equates to 2.9 billion barrels of oil on an equivalent energy content basis, and would have to be replaced with additional foreign imports worth over $90 billion at current prices. A little temporary relief for natural gas consumers thus directly leads to increased OPEC imports and higher prices for all consumers of heating oil, motor gasoline, and other refined products. This is a very misguided approach toward good energy policy.

As domestic supplies of natural gas decline, the fixed costs of transmission and distribution will have to be borne by fewer units of consumption and will therefore further increase the cost of each MCF supplied. Thus, a price freeze at the wellhead aggravates the rate of increase of those very elements which are causing a disproportionate share of higher residential prices today.

In our testimony before this committee earlier this year and in our testimony before the House subcommittee we pointed out that the NGPA has caused considerable disarray in natural gas markets. Due to the vastly uneven distribution of low cost regulated natural gas supplies among pipelines, some enjoy advantages over others in bidding for new supplies. Some pipelines are raiding the markets of others, threatening the financial viability of the losers. Market shares among competing manufacturers are shifting due to some having access to cheaper supplies of natural gas. This same disorder is also distorting inter-fuel competition. No region of the country is spared. A freeze of wellhead prices will perpetuate and aggravate these problems.

Directed contract abrogation is not the answer

A second group of proposals would abrogate or restrict the operation of take-or-pay clauses and direct a pipeline purchaser to take the least cost gas under contract to it. Some of these proposals would impose a strict requirement that a pipeline take the cheapest gas seriatim - a requirement that a pipeline take 100% of all of the 20¢ gas it has available under contract, then all of the 30¢ gas, $1.00 gas and so forth until its gas demands have been met. All of the more expensive contract gas would be shut in, but would remain committed to the pipeline; i.e., the producer would not be free to sell the gas to other purchasers. Those who advocate this "quick fix" see take-or-pay clauses as the root cause of higher gas prices, despite evidence that total abrogation of take-or-pay clauses would have minimal or no impact on residential gas bills,

As the General Accounting Office recently pointed out, the problem confronting the industry is far more involved and complex than the simple consequences of a take-or-pay clause in gas purchase contracts. I have attached to my testimony two papers that extensively discuss take-or-pay clauses and indefinite price escalator clauses, should the members of the Committee wish to examine these subjects in greater detail. I would request that these two papers also be included in the record.

I submit that the contracting practices of the producer and pipeline are not the cause of natural gas pricing distortions. The cause of these distortions is the NGPA itself and its 25 categories of gas. The solution to the problem is not to abrogate contracts entered into between the producer and the pipeline. Rather, the solution is to abolish the artificial and meaningless price differentials for a fungible and homogeneous commodity.

A legislative requirement that pipeline purchasers take the least cost gas under contract to them would have disastrous effects on the economy. The enactment of legislation requiring pipelines to purchase the least cost gas available to them would eliminate the production of deep gas, tight sands gas and, in many cases, substantial volumes of stripper well gas and gas from "new" wells.

It is not reasonable to expect continued exploration for high cost gas supplies if Congress enacts, even for short periods, legislation which prevents the production of that gas. Without these supplies, the impending shortage expected in the mid-1980's under current law will occur more quickly, and will be much worse than now expected.

Legislation directing the pipeline to purchase the least cost gas available to it would cause irreparable harm to the producing industry by rewriting existing contracts between producers and pipelines. Producers could not have entered into long-term supply contracts without the assurance of minimum levels of cash flow to recover their investment. Any least cost gas proposal would change the bargained-for agreement between the parties without a corresponding right on the part of either party to amend any other bargained-for provision. In the future, producers would be reluctant to enter into any long term supply agreements for future sales of gas for fear that the terms of the contract would be changed by Congress. I should mention in passing that public policy encourages, and in many instances requires by law that buyers and sellers enter into long-term contracts. If producers are reluctant to enter into new contracts and drill for new gas supplies, even for a few months, the implications for future supply are obvious.

Domestic producers witnessing 100% shut-ins of recently drilled wells and realizing that further investment in gas exploration and production is subject to short term political considerations will be uninterested in drilling additional wells. No producer, investor or banker could afford the risk of exploring for new reserves when its return on investment is subject to spasmodic federal intervention.

Producers have relied on the NGPA and have made investment decisions based on that structure. Requiring producers to continue to produce "old" gas priced below market and replacement cost levels but denying them the benefits of NGPA incentive pricing is unfair. Producers have drilled in reliance on the incentive pricing provisions of the NGPA and are entitled to rely upon NGPA's assurance that these prices are just and reasonable. Producers, faced with no return on their investment would be unable, in many cases, to service their debt, resulting in substantial defaults on hundreds of millions of dollars of outstanding loans. The economic impact that would follow would be very serious.

A least cost "directed purchase" requirement would also result in a further divergence of prices to consumers. So called "deep-cushion pipelines" (those which have a relatively large share of old low-priced gas) will in some cases be in a position to eliminate purchases of unregulated and high-cost gas entirely. Under these circumstances, the deep-cushion pipeline's average cost of gas would be reduced more than that of the "shallow-cushion pipelines" (those that have a small share of old low-priced gas) which must continue to purchase "high-priced" gas to meet customer needs. The consequence will be that customers of shallow-cushion pipelines will be at an even larger competitive disadvantage and possibly pay a higher price than under the NGPA as it now exists.

The deep-cushion pipeline will continue to have an advantage in bidding for uncommitted gas. In addition, it will have another advantage that did not exist under the NGPA. It would continue to have gas committed to its system without any obligation to purchase it. This gas may, in fact, be cheaper than uncommitted gas on which a shallow-cushion pipeline is bidding.

The "directed purchase" requirement also presents a constitutionality question. Through an act of Congress, pipelines would be statutorily induced to break contracts with producers and would be statutorily insulated from an action to recover the contract price. Producers would, during the time the law was in effect, receive no return on their investments and still incur some costs to maintain the properties. Moreover, the producer will be restricted by his contract and, in some cases by Section 7 of the Natural Gas Act, from selling his shut-in gas to someone else. The only remedy left to producers under such circumstances, would be to challenge the constitutionality of the law. A producer could present a Fifth Amendment case of a taking of private property for public use without just compensation. See, e.g., Lemmons v. United States, 495 F.2d 864, (Ct. Cl., 1974) (a leasehold interest is property for purposes of just compensation); R.J. Widen Co. v. United States, 357 F. 2d 988, 966 (Ct. Cl., 1966) (a temporary taking is compensable under the Fifth Amendment); Monongahela Navigation Co. v. United States, 148 U.S. 312,336-337 (1983) (the taking of a contract right is compensable under the Fifth Amendment); Pennsylvania Coal Co. v. Mahon, 260 U.S. 393, 416 (1922) (Justice Holmes) (the existence of a temporary emergency cannot avoid the requirement to pay just compensation: "We are in danger of forgetting that a strong public desire to improve the public condition is not enough to warrant achieving the desire by a shorter cut than the constitutional way of paying for the change"). A challenge, regardless of the eventual result, would take years to work its way through the courts and ultimately the Supreme Court. During this period, uncertainty will continue to plague the production industry resulting in a severe reduction in drilling activity.

"Backdoor" regulation creates an administrative morass

A variation of the "directed take" gas requirement appears in bills that have been introduced which seek to enlarge the authority of the FERC to review the purchase practices of natural gas pipelines. The Commission would be given the authority to limit or deny passthrough of purchased gas costs where the pipeline gas purchase contracts contain certain common pricing or take provisions.

While I am confident that spokesmen representing pipeline companies and the various pipeline industry associations will address these bills in greater detail, the NGSA is opposed to attempts to indirectly regulate or restrict existing contracts. These passthrough restriction bills attempt to indirectly limit or prohibit the operation of take-or-pay clauses, and indefinite pricing clauses in existing contracts. The NGSA opposes these indirect efforts for the same reasons I mentioned in connection with the direct proposals to interfere with these clauses - such interference would impair the producer's expected revenue stream, create uncertainty and possible collapse in the investment and lending communities, and have a chilling effect on further exploration and development programs that are needed to provide the gas for the future.

For example, some of the proposals would add a definition of the term "abuse," as it is used in Section 601 of the NGPA. Abuse would include imprudence on the part of a pipeline and the presence in any existing contract of a provision which materially prevents the pipeline from responding to changes in customer demand or other market forces. The presence of a take-or-pay percentage greater than 70 percent, an indefinite price escalator clause not tied to an economic indicator or a most favored nation clause, or the absence of a market out clause would, under the bill, create a rebuttable presumption of abuse.

Such proposals seek to give new direction to our gas pricing system through a seemingly minor amendment to the NGPA definition section. This type of proposal would allow the FERC to deny a pipeline passthrough of gas costs because a contract may have been negotiated and signed several years before this legislation was proposed or before the passthrough in question was challenged. In the face of this possible second guessing by Congress of the FERC, the pipeline may have no alternative but to attempt to avoid the obligations in his contract with the producer.

On the other hand, if the pipeline complies with the terms of the contract, Commission denial of passthrough, presumably only after notice and hearing, may occur months after the pipeline has paid the producer. In effect, a substantial portion of the payments made to producers would be subject to possible recoupment demands by the pipelines. This revenue uncertainty would create the same type of cash flow and financing difficulties inherent in the price freeze proposals I discussed earlier.

Pipeline management is squarely responsible for negotiating with producers for adequate supplies at competitive costs. The object of the NGPA was to ultimately achieve a free market to balance gas supply and demand over the long term. There was to be no "back door" continuing regulation of producer prices through reviews in pipeline rate cases; hence denial of purchase cost passthrough was limited in Section 601 of the NGPA to "fraud, abuse or similar grounds." Adding "imprudence" or similar phrases to these limited criteria would put us all back into a vague never-never land. Regulatory meddling rather than supply and demand might determine prices. There would be no price certainty because the rate proceedings would drag on for years. The uncertainty and any denials of passthrough would adversely affect supply and thus ultimately drive prices even higher.

For these reasons and others that will, no doubt, be raised by the pipeline representatives, the NGSA does not believe the proposed limitations on pipeline passthrough present either a workable or responsible solution to the many problems that exist in the natural gas industry.

A "Quick-fix" does more harm than good

In short, we find that the wellhead price of domestically produced gas has risen by 39¢/MMBTU during the last 12 months. The DOE reports that the average residential consumer pays about $5.60/MMBTU for natural gas. I repeatedly hear reports that someone's gas bill has doubled. It should be clear to all that 39¢ wellhead increase is in no way responsible for doubling anyone's $5.60 gas bill.

These piecemeal natural gas bills lately introduced are directed towards rolling back or limiting all or part of the wellhead price element - and 39¢ is a very small part of the total $5.60. The typical consumer will see very little change in his gas bills this winter even if these "quick-fix," piecemeal legislative proposals are enacted.

But, these misguided policy proposals will be harmful to natural gas consumers and all citizens in the future. Domestic exploration and production will be stifled, shortages will again occur, and our nation will become more reliant on OPEC oil and other energy imports.

We do have serious flaws in our current natural gas policy, but the piecemeal approach toward partial solutions introduced into the House and the Senate will do little good, and significant harm. We again urge that the Congress comprehensively review the entire Natural Gas Policy Act of 1978 as soon as possible.

I would be pleased to answer any questions that you may have.

Attachment 1 to the testimony of Nicholas J. Bush for the Natural Gas Supply Association, before the Senate Committee on Energy and Natural Resources, December 13, 1982.

STATEMENT OF THE NATURAL GAS SUPPLY ASSOCIATION
BY NICHOLAS J. BUSH, PRESIDENT
BEFORE THE SUBCOMMITTEE ON FOSSIL AND SYNTHETIC FUELS
OF THE HOUSE COMMITTEE ON ENERGY AND COMMERCE

SEPTEMBER 20, 1982

My name is Nicholas J. Bush, and I am President of the Natural Gas Supply Association, an organization of producers who market about 90% of the nation's natural gas.

First, the Association commends the Subcommittee for undertaking this comprehensive series of hearings to examine the implementation of the Natural Gas Policy Act and its effect upon all aspects of the natural gas industry. The record already compiled represents a significant contribution to our knowledge of the natural gas issue. NGSA particularly thanks the Chairman and his staff for affording us the opportunity to participate in today's examination of the NGPA's impact upon natural gas markets.

NGPA's Impact Upon Production Economies: A Pattern of Distortion

A basic premise of the NGPA is that the nation's experience with wellhead price regulation from 1954 to 1978 was a failure, and that the country should move toward a free market for natural gas. Free markets are far better allocators of resources than are regulators. Markets provide consumers with accurate price signals concerning the real value of various commodities available for purchase, thus inducing optimal demands. At the same time, free markets send accurate signals to suppliers of commodities regarding the value of the products they supply. Producers can then make realistic decisions regarding levels of investment and production. In this way, supply and demand are balanced, and markets are cleared.

A primary weakness of the NGPA is that it provides a slow and inefficient transition to a free market for natural gas field prices. During the transition period producers, purchasers and consumers must deal with a system of numerous price categories based on factors other than the value of the commodity being sold. The NGPA system of multiple price categories and only partial decontrol even after January 1, 1985 results in a pattern of supply incentives quite different from those which a free market would provide.

Regulation of the domestic natural gas market creates irrational economic incentives. Pricing significant quantities of gas below market encourages the purchase of marginal supplies at prices higher than market-clearing levels. For example:

- An interstate pipeline has recently proposed to import 186,200 Mcf of Canadian natural gas to its facilities in the Midwest. The border price of $4.94, substantially exceeding the 102 new natural gas price ($3.20), plus the additional price markups due to transportation through two other interstate pipelines in order to reach the buyer's system, will result in burner tip prices well above the price of competing fuels. The buyer contends that this expensive transaction is necessary because its traditional onshore and offshore supply areas are "mature and declining."[1]
- Another company is currently planning to buy Algerian liquified natural gas for which it projects a delivered purchase price of $7.16 per Mcf, exclusive of transportation and distribution costs. This purchase will amount to 3.3 Bcf of LNG over the next 20 years. This expensive incremental component will constitute roughly 30% of the pipeline's supply.[2]

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[1] See FERC Docket 82-08-NG and Application CP82-419-000.

[2] See FERC Application CP74-138 and subsequent amendments.

These situations illustrate that price regulation under NGPA affords an incentive to roll-in high-cost gas supplies while inhibiting the maximum development of conventional domestic supplies. Even in a widely recognized atmosphere of excess gas deliverability, and the availability of cheaper domestic supplies, these above-market foreign purchases indicate that the NGPA continues to provide gas purchasers with erroneous signals which distort current market realities.

It is not surprising that this situation has led gas distribution companies and users around the country to challenge additional purchases of high-priced imported gas by their suppliers, since natural gas prices are reflected in distribution company charges and in products manufactured by gas users. The artificially high-priced supply increments may render them unable to compete in their respective markets. Unfortunately, attempts to deal with this problem by denying passthrough threaten the economic viability and long-term supply of the pipeline. In order for the entire industry to function properly, regulated wellhead prices must be allowed to seek a free market price. This would eliminate the uneven distribution of this vintaged gas among different pipelines and the subsidy for expensive imports of natural gas which otherwise NGPA both provides and perpetuates.

Imported natural gas increments also seem to be relatively insulated from current market situations. It is interesting to note that the only prices perceived by some to be above longterm market-clearing levels which have reacted to the current market surplus are those paid for "deep" natural gas. Deregulated deep gas prices have risen to market prices of up to $10.00 per Mcf, leading several pipelines to trigger "market-out" clauses which either reduce the price of this gas or eliminate it from the pipeline supply mix.[3]

Reserve Additions under NGPA: The Long-Term Perspective

The nation's gas supply as measured by the level of proved reserves in the last 15 years shows a dramatic decrease in total inventory. At the end of 1967 proved gas reserves in the lower 48 states totaled about 289 Tcf. At the end of 1981 that inventory had declined to about 167 Tcf. In other words, we have liquidated 43% of our proved reserve base - about 122 Tcf - in only thirteen years.

Over the past decade reserve additions, including revisions and corrections, show that we have produced from inventory approximately 1.6 times more gas than we have discovered.

Table 1

Relationship of Lower 48 Reserve Additions to Production 1967-1981 (Tcf)[4]

Year	Reserve Add.	Production	Year	Reserve Add.	Production
1967	21.0	18.3	1975	10.1	19.6
1968	12.0	19.3	1976	7.5	19.3
1969	8.3	20.6	1977	13.0	18.6
1970	11.1	21.8	1978	19.4	18.6
1971	9.4	21.9	1979	11.8	19.0
1972	9.4	22.4	1980	15.4	18.5
1973	6.5	22.5	1981	21.3	18.5
1974	8.3	21.2	Average	12.3	20.0

[3] A market out clause allows, under certain stipulated conditions, the pipeline to offer the producer a lower contract price than the contractually established price.

[4] Source: 1967-76 Data-AGA; 1977-81 Data-EIA

The Department of Energy has reported that U.S. proven reserves of natural gas increased by 2.7 Tcf during 1981 to a level of 201.7 Tcf at year-end. This is the first reported increase since the addition of Prudhoe Bay gas reserves in 1970, and is certainly welcome news. However, it would not be prudent to interpret this positive event as indicating that a comfortable supply situation exists for the intermediate term. During 1981 drilling efforts achieved record highs for both oil and gas completions, yet the 17.2 Tcf of new gas discoveries (including extensions to known reservoirs) still lagged behind production of 18.7 Tcf. Only the inclusion of net positive revisions and corrections totaling 4.2 Tcf made possible the slight gain in total reserves at year-end. The revisions and corrections category is largely a statistical aberration, and should not be viewed as indicating a trend. More importantly, drilling activity during 1982 has declined from the record levels achieved last year and will undoubtedly have a negative impact on 1982 reserves additions.

Despite current perceptions of excess deliverability, since 1967 producers have been unable to add new reserves at rates adequate to stem the depletion of long-term gas inventories.

According to the Federal Energy Regulatory Commission, interstate deliverability from interstate reserves contracted for as of January 1, 1982 has substantially declined, a fact which highlights the temporary character of current excess deliverability. Between 1981 and 1986 supply from presently connected reserves will decline by 49%, and between 1981 and 1991 by 76%.[5] Specifically, interstate pipelines have continually expressed concern about the expected decline in natural gas deliverability from the major producing region of the Texas-Louisiana Gulf Coast, where large volumes of gas reserves are being depleted at very rapid rates. Data supplied by the

[5] FERC Docket GP82-47, August 6, 1982

pipelines for this region indicate an expected turning point in deliverability within the next three to five years, with a steep decline in gas production thereafter.

If these rapid decline rates are not offset by greater discoveries than those in the recent past, we will witness a continued decline in the reserves to production ratio ($^R/p$) as we have in the last 15 years. From 1967 to 1980 the $^R/p$ ratio for gas dedicated to interstate pipelines declined significantly, from 16.8 to 8.4.

The only method of proving additional gas reserves is by drilling wells. However, no dramatic increase in gas drilling activity followed passage of the NGPA in November, 1978. Although absolute numbers of gas wells continued to increase prior to this year the rate of increase has actually declined since passage of the Act. In the three years immediately prior to NGPA's enactment (1976-78) gas drilling increased at an annual rate of 20%. In the three years subsequent to passage, the average annual rate of increase dropped to only 11%.

It should be noted that the post-NGPA period coincides with the phased decontrol of crude oil prices which began in May 1979 and concluded with complete decontrol of oil prices in January, 1981. Oil wells drilled in 1980 increased 39% over those drilled in 1979 and 1981 saw an increase of 40% over the 1980 figure. This is clear and convincing evidence of the effect of free market price incentives on drilling efforts.

Unfortunately, while NGPA fails to spur a sustained and balanced overall increase in gas drilling efforts, above market clearing prices for deep natural gas have resulted in the allocation of scarce drilling capital to this high-cost area of gas exploration. According to the Federal Energy

Regulatory Commission, the price of deep gas averaged $7.53 MMbtu in July 1982,[6] when the national average interstate wellhead gas price was $2.60.[7]

Drilling statistics compiled by the American Petroleum Institute demonstrate NGPA-induced distortions in drilling behavior.

Table 2

EXPLORATORY GAS WELLS DRILLED[8]

Depth (feet)	1980	1981	Change
0- 5,000	809	1085	34%
5,000-10,000	691	788	14%
10,000-15,000	360	342	-5%
15,000 and Below	109	157	44%

Exploratory drilling at near deep levels shows that in 1981 the number of gas wells drilled between 10,000 and 15,000 feet declined 5% while exploratory deep drilling increased 44%. The statistics also reveal a concentration of drilling in shallow onshore fields, which under NGPA receive a higher price relative to the cost of drilling than deeper fields (less than 15,000 feet), or offshore wells. These shallow wells do not add a great deal of long-term reserves but increase deliverability over the short-term. A large gap in incentives is created by NGPA in the depth range of 5,000 - 15,000 feet. The domestic resource base is not being developed at these depths under NGPA, because of the misguided attempt to "fine tune" incentives. Geologists spend their careers attempting to select the most favorable (i.e. low unit cost) prospects for drilling in all depth ranges. These efforts are thwarted by a price structure which artificially prices gas at different levels. Obviously, higher than market prices have led to more deep gas drilling than would be justified if more economic sources of additional supply were the first to be exploited. Just as deep gas prices have caused drilling distortions, low price ceilings on old gas (NGPA secs. 104, 106, 109) deny producers capital needed to finance an expanded search for gas, and preclude full exploitation of sources of production for which exploration and most development costs have already been incurred.

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[6] FERC Purchased Gas Adjustment Filings Effective in July, 1982.

[7] EIA Summary of Interstate Pipeline Receipts and Disposition of Gas.

[8] Annual Summary of Drilling Statistics, API, March 19, 1982.

Because drilling activity is price-sensitive, the latest statistics give reason for concern. These data indicate that gas well completions have held up in the first half of 1982; however, completions are expected to decline in the last half of 1982 because of a precipitous decline in drilling rig activity.

According to Hughes Tool Company weekly drilling rig activity reports, drilling increased steadily through 1980 and 1981. However, the number of active drilling rigs peaked at 4,530 on December 28, 1981, and declined steadily through 1982 to the latest rig count of 2,499.[9] Much of the decline in drilling activity is clearly attributable to declining oil prices, but the magnitude of the decrease also portends a decline in gas well completions. 1982 may thus be yet another year in which gas consumption exceeds proved reserves additions, with a corresponding drop in total proved reserves and the reserves to production ratio. Historically, rig counts have a direct relationship to reserve additions, as is demonstrated in the following table:

[9] Hughes Tool Company Weekly Drilling Rig Count.

Table 3

Relationship of Rig Count to Reserve Additions (Tcf)[10]

Year	Rig Count	Reserve Additions
1973	1194	6.5
1974	1472	8.3
1975	1660	10.0
1976	1658	7.5
1977	2001	13.0
1978	2259	19.4
1979	2177	11.8
1980	2909	15.4
1981	3907	21.3

Adequate Gas Resources Are Available To Be Found and Developed Under Sound Policy

The nation's remaining conventional gas resource base is very large, as measured by proven reserves and expert opinion on the potential resource base. But these supplies will be discovered and developed only if an adequate drilling effort is forthcoming in response to adequate economic incentives.

Both the Potential Gas Committee and the U.S. Geological Survey use an attribution method to estimate potential gas supplies. This method considers the actual occurrences of natural gas and the conditions which surround those occurrences. The Potential Gas Committee's most recent estimate of conventional potential gas supplies is 913 Tcf. The mean estimate of the Geological Survey is 772 Tcf of conventionally recoverable reserves. These estimates plus proved reserves would provide 48 to 55 years of production at current levels.[11] However, these reserve estimates are made on the assumption that prices will be received for the gas which are high enough to return costs and an adequate return on each project

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[10] Rig count data from Hughes Tool Company weekly Drilling Rig Count; Reserve additions data for years 1973-76 from AGA, 1977-81 data from EIA.

[11] Potential Gas Committee, Potential Supply of Natural Gas in the United States (as of December 31, 1980). Also see Statement of C.M. Allen in FERC Docket RM82-26, appended hereto as Attachment 3.

Market Ordering: Current Manifestations of a Real and Serious Problem

It has been apparent for some time that the law is unlikely to achieve the smooth transition to partial decontrol in 1985 which its authors and Congressional supporters anticipated.

Market ordering problems arise from the price structure of the NGPA and the historical distribution of low-priced NGPA gas among interstate pipelines and between the interstate and intrastate natural gas transmission systems. We have heard these problems expressed in previous Congressional hearings. The various testimonies confirm that there is a substantial old gas cushion enjoyed by some pipelines which provides those pipelines and their customers with significant advantages over those without cushions.

A "Price Cushion" Problem Exists

The vintage price system established originally by the FPC, and vastly expanded by the multiple categories created by Congress in the NGPA, created favored categories of consumers who are subsidized at the expense of other consumer groups; favored pipelines whose weighted average cost of gas is less than half that of other pipelines;[12] and favored producers who receive up to twenty times more for their gas than do other producers.[13]

In setting out the many different categories for gas price ceilings in the NGPA (as well as previous Commission-determined ceiling prices under the Natural Gas Act), the primary objective was to place the price incentives in those categories which would elicit the greatest supply response, while withholding incentives (or even cost recovery) to those categories which were not likely to yield much additional gas.

[12] See attachment 1: Brickhill, Statement With Respect to Pricing Disparities Under NGPA, p. iv.

[13] See e.g., FERC Docket No. RM80-53, GAO Report to Senator Metzenbaum, April 6, 1982.

Apparently, the drafters of the NGPA did not appreciate the adverse consequences resulting from the uneven distribution among various interstate and intrastate pipelines of the volumes of gas still under control.

Mr. John A. Brickhill of Foster Associates, Inc. has made a study[14] which analyzes the weighted average cost of gas for the twenty-seven largest interstate pipelines and nine intrastate pipelines for 1980, 1981, and March 1982. Mr. Brickhill also projects a weighted average cost of gas for the interstate pipeline companies as of June 1985 in constant 1981 dollars. The most recent data available (March 1982) show a range in weighted average purchase cost of gas for interstate pipeline companies from $2.07 per Mcf (Northern Natural Gas Company) to $5.39 (Pacific Interstate Transmission Corporation). When those pipelines which are dependent on imported gas or SNG are eliminated, the range in price due solely to the difference in the NGPA categories ranges from the $2.07 weighted average cost for Northern to $3.42 for Mississippi River Transmission Corporation, for a differential of $1.35 per Mcf. Mr. Brickhill projects that by 1985 the differential will have increased to $1.44 ($3.31 for Northern to $4.75 for Mississippi).

Similarly, the weighted average cost of gas for intrastate pipelines varies from $4.07 for Sugar Bowl Gas Corporation to $2.65 for Oklahoma Natural Gas Company. When only Louisiana intrastate pipelines are considered, there is still a differential in the weighted average cost of gas of $1.10 (Sugar Bowl - $4.07 versus Monterey Pipeline Company - $2.97) in March 1982.

Mr. Brickhill first analyzes the discrepancy between the interstate pipelines as a group and the intrastate pipelines as a group.[15] For the most recent period, March 1982, the weighted average cost of gas for the interstate pipelines was 85 cents an Mcf less than that of the intrastate pipelines ($3.57 versus $2.72). If one uses a median figure, the differential is 86 cents ($3.60 versus $2.74). What this means to the competition for new gas supplies in the major producing areas of Texas, Louisiana, and Oklahoma is illustrated on Table 2 of the Brickhill study attached.[16]

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[14] Appended to this statement as attachment 1. Cited hereafter as Brickhill.

[15] Brickhill, Table I, p. iii

Restricting the comparison to the interstate pipelines which buy in major producing areas, the weighted average cost of gas of those interstate pipelines was 96 cents less than their intrastate competitors ($3.57 versus $2.61 per Mcf). This was an increase in the differential of 34 cents over 1981. The effect of this price differential is dramatically illustrated in the following Table which shows that from 1969 through 1977 the interstate market purchased only minor amounts of new onshore reserves, but after that date interstate pipelines were able to purchase almost all of the new onshore reserve additions.

Table 4

INTERSTATE AND INTRASTATE NATURAL GAS RESERVE ADDITIONS[17]

1965-1979 (In Tcf)

Year	Interstate Reserve Additions, Excluding Gulf of Mexico	Intrastate and Uncommitted Reserve Additions
1965	9.59	5.24
1966	10.52	3.53
1967	11.10	5.08
1968	5.94	3.87
1969	0.42	5.78
1970	(3.29)	8.95
1971	0.98	4.63
1972	(3.13)	2.48
1973	(0.44)	5.10
1974	(0.47)	6.49
1975	(0.57)	4.95
1976	0.32	3.32
1977	0.71	6.31
1978	6.79	0.93
1979	9.58	0.44

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[16] *Id.*, Table 2, p.v.

[17] Source: "Intrastate and Interstate Supply Markets Under the Natural Gas Policy Act." DOE/EIA-0309. October, 1981. p. 37. The amounts are not inclusive of Outer Continental Shelf reserves that are exclusively available to interstate buyers.

Mr. Brickhill anticipates that with partial decontrol under the NGPA in January 1985, a greater proportion of intrastate gas will be decontrolled than interstate gas. Thus, the present advantage enjoyed by the interstate pipelines will be increased. If the market is to move toward an orderly posture, the interstate and intrastate pipelines must be brought toward a comparable status.

Mr. Brickhill then addresses the differential between the weighted average cost of gas of the individual interstate pipeline companies. He notes that there was a difference of 194 percent between the highest and lowest cost pipelines in 1981. The dramatic differences in the weighted average cost of gas between pipelines is a direct result of the percentage of Section 104 and 106 gas in the total gas supply purchased by each pipeline.[18] (The total breakdown of each of the twenty-seven interstate pipelines' gas supply by pricing category is shown on Schedule 4 of appendix 1).

Mr. Brickhill proves the definite relationship between the percentage of Section 104, 106 and 109 gas in the volume of purchased gas by a pipeline [19] and the weighted average cost of gas for that pipeline. The "coefficient of variation," or the difference in the average cost among pipelines varies even more widely when the Section 104 category is broken down into its vintage components. [20] The spread in vintage pricing is dramatic (44.7 cents to $2.20). The difference in the percentages of the oldest vintage owned by various pipelines is also dramatic - a range of almost 200 percent. Thus, the statistical averaging process conceals the magnitude of the variation in gas costs among pipelines.

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[18] Brickhill, Schedule 3.

[19] Id., pp. 4-8.

[20] Id., Tables 5 and 6.

Mr. Brickhill then calculated the percentage of each pipeline's gas market in each of eleven regions shown on the map.[21] He was thus able to show a breakdown of the gas supply of each region by the NGPA category, both by percentage and by price.[22] Schedule 9 shows the wide variation in the weighted average cost of gas between regions due solely to the differing volumes of gas in different categories purchased by the pipelines which supply that region. By far the highest cost of gas is in the Pacific Northwest ($3.52 per Mcf), which obtains 53 percent of its gas from Canada. The lowest gas cost is enjoyed by the West North Central Region ($1.94 per Mcf) which has 54.1 percent of its supply in the Section 104 category.

Pipelines Which Enjoy a Large Price Cushion Will Have An Advantage in Competing for New Gas Supplies

Pipelines enjoy a price "cushion" due to certain categories of gas remaining under price controls, so that the "rolled in" price (same as the weighted average cost of gas calculated by Mr. Brickhill, plus pipeline transportation charges) is relatively low. Because the reserve life index of all pipelines is small (the most recent national figures for the lower 48 states show 9:1 reserves to production ratio),[23] all pipelines need continually to contract for new supplies to replace those being consumed by their customers. Low cushion pipelines, which must buy gas in competition with high cushion pipelines in a partially decontrolled market, will be under a severe disadvantage. This is because the high cushion pipeline can pay higher prices for decontrolled gas without increasing the average rolled-in price to its customers above the commodity value, which would cause fuel switching.[24]

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[21] *Id.*, Schedule 6.

[22] *Id.*, Schedules 7 and 9.

[23] Pipeline reserve to production ($^{R}/_{p}$) ratios in 1968 averaged 14.6. From AGA and EIA Data.

As shown by Mr. Brickhill's study,[25] the disadvantage which intrastate pipelines have in the present market for gas will increase in 1985, because a greater portion of their supplies will be decontrolled at that time. Mr. Brickhill estimates that under the conditions existing in March 1982 an increase in the ceiling price of Section 104, 106 and 109 gas of $1.94 above present levels would be required to equalize the mean cost of gas between interstate and intrastate pipelines.[26]

[24] The extent of this phenomenon has been developed in various papers and publications. See "Overview of Policy Issues: A Preliminary Assessment" by Milton Russell, dated March 11, 1982; "Analysis of the Bidding Disparity Between Interstate and Intrastate Pipelines" by Robert C. Means, Director of the Office of Regulatory Analysis, March 10, 1982; and "Pitfalls on the Road to Decontrol" by Catherine Good Abbott, Director, Division of Energy Regulation, Office of Policy, Planning and Analysis, Department of Energy.

[25] Brickhill, pp. 14-16.

[26] Id., p. 19

The foregoing problems which are expected to occur in the first quarter of 1985 if the NGPA is allowed to run its course without Congressional action were first documented fully in a five volume study published by the Office of Policy, Planning and Analysis of the U.S. Department of Energy, entitled "A Study of Alternatives to the Natural Gas Policy Act of 1978" in November 1981.

Extensive testimony was given before the Senate Energy Committee in November 1981 and March 1982 by FERC Chairman Charles M. Butler, the Office of Policy, Planning and Analysis of the Department of Energy, the Petrochemical Energy Group, the Independent Petroleum Association of America, a Coalition of Intrastate Pipelines, the Chemical Manufacturers Association, and this Association, all pointing to the "market order" problem as a matter of such serious concern that the Congress should take immediate remedial action.

NGPA Impact in the 1982-1985 Period

The current pricing structure is unlikely to provide a smooth transition because the NGPA underestimates the price for oil in 1985, and because of the bidding phenomena that could result from the cushion of undervalued gas. The gas consuming public could, therefore, expect an increase in the price for gas in 1985, as long as the alternative fuel price in 1985 exceeds controlled gas prices in 1984. The magnitude of the increase will also be influenced by the supply of and demand for gas and the size of the old gas cushion.

The old gas cushion creates the possibility that the price for decontrolled gas could be bid up above the market clearing price. As a recent DOE report stated: "The NGPA cannot deliver the hoped-for price benfits created by continued price controls on old gas to existing customers. In effect, partial decontrol requires that the benefits of price-controlled gas be captured by producers through high deregulated gas prices in order to avoid curtailments."[27]

If the price of gas is artificially set at a level below its value in the market, false signals are given to both those who supply gas and those who demand gas. Supply will be less than in a free market because of the depressed value placed on it, and for the same reason demand will be greater. Energy consumers who place a high value on natural gas may be unable to acquire it because of the reduced supply. These consumers must instead turn to more costly alternatives, including imported oil.

On the other hand, users who would conserve or convert to alternative fuels if the real price for flowing gas were not artificially set below that of alternative fuels are encouraged by bargain prices to uneconomic consumption. An undervalued gas supply will unnaturally command a larger than appropriate share of energy consumption. Hence, there is inefficient use and waste of a valuable energy resource. Dr. Paul MacAvoy of Yale suggests[28] that false signals are given by the current NGPA pricing levels and that the mid-eighties will see supply shortages and unsatisfied demand. These factors would exert upward pressure upon the price of gas in 1985.

[27] Office of Policy, Planning and Analysis, U.S. Department of Energy, A Study of Alternatives to the Natural Gas Policy Act of 1978; (1981), p. 4

[28] "Statement of Professor Paul W. MacAvoy on the Impact of Pricing Alternatives on Natural Gas Industry Performance," Appendix I of Joint Comments of Indicated Producers in FERC Docket No. RM82-26, Impact of the NGPA on Current and Projected Natural Gas Markets, p.34.

NGPA Should Be Amended

Forty-three of the forty-eight witnesses who have appeared before the Subcommittee in this series of hearings have criticized the impact of NGPA on themselves or their constituency, and have advocated significant amendment to or abandonment of the Act as an appropriate solution. The proposed solutions vary widely, but this does not change the consensus opinion that NGPA in its current form does not work.

In retrospect, the fact that the NGPA has not lived up to the expectation of its proponents should surprise no one. Any group of legislators, presented with the task of reconciling diametrically opposed approaches to natural gas policy, would find the task difficult.

Fortunately, the conferees, with the endorsement of the House and Senate, left more of substance in the NGPA than the Act's complex pricing structure. The conferees chose decontrol as the appropriate long-term answer to our natural gas supply problems.

NGPA's pricing structure, in the case of new gas, serves merely as a bridge from the previous FPC pricing policies, which were repudiated, to new gas deregulation in 1985 (or in some cases, 1987), which was endorsed. The continued controls on old gas prices under NGPA do not detract from this analysis. Implicit in the concept of "old gas" is the fact that it is an isolated, finite component of our gas supply, which runs out over time and is then replaced by deregulated new gas supplies. Seen in this light, the current problems under NGPA demonstrate only the need for a more effective transition mechanism.

Phased, Total Decontrol is a More Efficient Alternative

The solution lies in extending the decontrol concept to the pre-1985 period, and including old gas among that which is gradually deregulated. A phased decontrol of all natural gas will eliminate market disorder and other economic distortions caused by the uneven distribution of subsidized old gas supplies. It will provide a smooth transition to the completely deregulated market after January 1, 1985, and elicit additional gas production as an added dividend.

Decontrol Means Increased Gas Supply

Decontrol will provide the unequivocal economic signals leading towards the optimal exploration and intensive development of what most experts agree is a very large remaining resource base. Estimates of what may be accomplished in this regard can only be proved through experience, but some quantifications of this potential indicate that the additional supply response might be quite significant.

This Association recently commissioned a project to develop a model to assess impacts of alternative price scenarios, prepared by Edward W. Erickson, Professor of Economics and Business at North Carolina State University.[29] The model report is appended hereto as Attachment No. 2. The model results indicate that a phased approach beginning on January 1, 1983 leading to the wellhead decontrol of all gas by January 1, 1985 could in this decade develop an additional 25 Tcf in reserve additions over and above that expected under continued experience under NGPA. These additional reserves would result from a more extensive exploration and drilling effort and from price-induced activities to extend reserves in known fields. Larger proved reserves will support increased rates of production to meet future demands.

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[29] Edward W. Erickson, Measuring Natural Gas Supply Response, Financial Flows and National Benefits of Wellhead Price Policy Options, August, 1982. Appended as Attachment 2.

An incremental gain of 25 Tcf in proved reserves additions within one decade is significant, being more than one year's domestic consumption of natural gas.

An expansion of the domestic gas supply of this magnitude would have substantial benefits to the security and economy of our nation. As the marginal energy supply is oil and gas imports, increases in domestic supplies will reduce dependence on these imports. This has important consequences for our national security. Further, expenditure of dollars within the United States benefits our domestic economy, rather than exporting dollars overseas. Still other benefits are realized by reducing use of gas by consumers who have no incentive to conserve because of artificially low prices. On the supply side, greater efficiency is obtained because of the ability of producers to direct their exploration efforts toward gas with the lowest unit cost, regardless of depth or category. These advantages far outweigh the transitional costs of more rapid decontrol of gas.

The supply model[30] in Attachment 2 is a tool to evaluate relative changes of different pricing options as they affect natural gas reserves, reserve additions and production and the resultant revenue and benefit distribution. The model builds upon actual experience and relies upon Professor Erickson's judgment and a survey of other expert opinion to project likely supply availability into the future. The model explicitly considers a large number of specific categories of gas production, successful gas completions, reserve additions per successful completion, $^{R}/_{P}$ ratios, and price-induced reserve additions at the intensive margin of

[30] See footnote 29.

development for already discovered reservoirs. The model also explicitly incorporates the price effects of three broad categories of contract provisions: fixed price and escalation, area and national rate, and indefinite price escalation clauses. These contract provisions, together with regulatory and market considerations, influence the weighted average cost of gas. Net producer wellhead prices are derived from explicit consideration of royalties (federal, state and private) and severance and property taxes, including typical severance tax reimbursement provisions where appropriate. Net producer wellhead prices drive supply response -- both from new wells and reserves and production enhancement. The model incorporates present production discounting for regulatory and market uncertainty and adjustment for normal production declines over time for a typical reservoir. Transitions among NGPA pricing categories exist to reflect the rollover of some contracts and the decline of production for certain wells into stripper well status. Demand considerations are implicitly included by assuming that all available gas can be sold so long as it is priced at or below the market-clearing wellhead price derived from alternative fuel costs at the burner tip with appropriate adjustments.

Studies by the DOE and others clearly demonstrate that the short-term macroeconomic consequences of an accelerated, phased approach to total wellhead decontrol are small and fleeting, while the long-term benefits are an important contribution to our nation's well-being.

Decontrol Will Eliminate NGPA Induced Market Disorder

Decontrol will also end the market disorders caused by the uneven distribution of the old gas cushion. Phasing-up old gas prices to market levels eliminates the gross disparities in average costs among interstate pipelines and between them and the intrastate natural gas transmission systems. As old gas prices increase, pipelines which have gained the advantages of an old gas "cushion" through historical accident will no longer face pressure to bid above market-clearing prices for natural gas without inhibiting the ability to compete with other pipelines for gas sales customers. A phased decontrol schedule leading to the elimination of all price controls on a date certain would lead to the reduction of policy-induced distortions in the competition for new supplies.

A "Contract Fix" is Not the Answer

We note that some witnesses before the Subcommittee advocate the Congressional abrogation or restriction of indefinite pricing clauses and take-or-pay clauses as a solution to the problems currently experienced under the NGPA. Such a simplistic approach is no solution. The problem confronting the industry is far more involved and complex than the simple consequence of a take-or-pay or pricing clause contained in individual gas purchase contracts entered into by buyers and sellers depending on their individual circumstances.

In addition to failing to solve market disordering problems, abrogation of indefinite pricing clauses and take-or-pay clauses will create other severe problems for producers and pipelines. These clauses were developed to meet real needs of both parties, and are integral and indispensible parts of the contracts in which they are found. In order to understand the function of these clauses, some explanation of the background and purpose of these clauses is useful.

Indefinite Pricing Provisions Are Necessary In Gas Sales Contracts and Serve the Public Interest

With the construction of major interstate pipelines, vast new markets for natural gas were developed. With the increased demand for gas, a very significant change occurred. Contracts for gas were being written for much longer terms than before, often for at least twenty years and sometimes much longer, as in contracts covering the producing life of a property which could last fifty or more years. This change to extremely long-term contracts was necessitated by the need for significant capital to finance these new interstate systems. To obtain the necessary permits, certificates, and approvals, the FPC, the Securities and Exchange Commission (SEC), and the investors who were providing the money had to be convinced that sufficient volumes of gas were committed to the project to satisfy the pipeline's market demand, amortize its indebtedness, and provide a reasonable expectation of profit. Both the regulatory agencies and the pipeline companies' bond buyers insisted upon firm long-term contracts for established volumes of gas for the full term of the bonded indebtedness. Thus, in order to sell his gas to the burgeoning interstate market, the producer was forced to acquiesce in contracts of long duration.

This presented a monumental problem for the producer and the pipeline. How could they assure that the price for gas over protracted periods would equate to the market value when economic conditions could present potentially numerous unforeseen variables affecting the gas sale? These long-term contracts required one of two things; either a fixed price or fixed pricing structure for the gas which required almost mystic clairvoyance of future long-term economic conditions or some pricing provision which was both rational and flexible and could assure the parties that the commodity was being sold at a price competitive through time with other sales of gas and substitutable fuels. The pricing device developed to achieve this end beame generally known as an indefinite price escalator clause. These clauses took various forms.[31] One early commentator noted their importance with respect to assuring receipts of fair value for lengthy periods of time:

> In spite of the criticism of price escalation clauses, there is nothing intrinsically wrong with them. Natural gas is the only commodity which is bought and sold under contracts of such duration. These clauses are designed to give the producer the market value of his gas production over the life of the contract. They are helpful to the pipeline purchasers and the consumer in that instead of averaging the fixed escalations over the life of the contract and specifying one price in the instrument, advantage is taken of the lower prices at the outset of the contract term with the increases occurring after the pipeline has established its business and presumably reduced its long-term debt.[32]

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[31] The most common of these are favored nation, redetermination, renegotiation, and alternate energy source clauses. The NGPA defines indefinite price escalator clauses as including "any provision of any contract --

> (i) which provides for the establishment or adjustment of the price for natural gas delivered under such contract by reference to other prices for natural gas, for crude oil, for refined petroleum products; or
>
> (ii) which allows for the establishment or adjustment of the price of natural gas delivered under such contract by negotiation between the parties. See 15 U.S.C. §§ 3315(b)(3)(B).

[32] Gregg, "Negotiating and Drafting Gas Purchase Contracts on Behalf of the Seller," 13 Annual Institute on Oil and Gas Law and Taxation, Southwestern Legal Foundation, 1962, pp. 90-91.

Indefinite pricing clauses have played a critical role in the gas producing industry's efforts to develop over the years sufficiently attractive marketing arrangements to enable the producers to maintain high levels of exploratory and developmental activity and give the pipeline assurance that it would pay no more than market value for the gas. Without the use of such pricing devices, the parties would be at the mercy of economic conditions affecting gas sales which could not be foreseen at the time of contracting. It is probably safe to say the magnitude of interstate gas service today is directly attributable to the long-term commitments spawned by the flexibility inherent in indefinite price escalator clauses.

In short, indefinite pricing clauses are and have been an essential feature of gas sales contracts and, if the domestic gas producing industry is to continue production of adequate supplies in the future, such clauses will continue to be a key contracting element. The importance of the indefinite pricing clauses was aptly summed up in a recent Wyoming Supreme Court decision enforcing a favored nations clause:

> Favored nations clauses are a common feature of gas purchase and sale contracts. The nature of the product and its questionable availability engenders reluctance on the part of producers to enter into long-term contracts at the price prevailing at the time of the contract. Yet purchasers require long-term commitments to insure an adequate supply of gas.[33]

Next to the pricing provisions, the most important provisions of a gas sales contract are those which specify the quantity of the gas to be purchased on a daily, monthly, and annual basis. The producer wants to sell his gas as rapidly as his wells will produce it, and the pipeline can take the gas into its facilities. Hence he tries in the contract to require the buyer to take as high a percentage of the his wells' capacity to deliver gas as he can. During the shortage period in the late 1970's, pipeline buyers, who needed more gas than they could buy in the shortest possible time, were willing to sign long-term contracts providing for high percentage "takes" from the producer. In many cases the producers drilled additional wells to enable the gas to be produced at a more rapid rate, to meet the urgent pipeline demand.

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[33] Amoco Production Co. v. Stauffer Chemical Co. of Wyoming, 612 P. 2d 463 (Wyo. 1980).

From the viewpoint of the pipeline, it is desirable to get as many gas reserves contracted to the pipeline as possible in order to protect the long-term supply security of the pipeline and its customers. The need must be considered with, or balanced against the short-term need to meet all the current demands of its customers. Thus, the pipeline buyer must adjust its gas purchase program to continually assure its long-term supply, while at the same time assuring itself that it has enough gas to meet all of its customers' demands, but not too much gas so that it would be found to violate the "take" or quantity provisions of its contracts with its various producers.

It is important to keep in mind that in talking about "producers" or "sellers" one is not talking about a single company or even a small group of companies. Instead pipelines buy from thousands of producers, and have individual contracts with each one. In fact, if the producers are selling gas from the same reservoir, the gas will move underground through the rock to the wells which are producing, and away from wells which are shut-in. This means that the producer whose wells are not producing can actually have his gas drained away by a producer whose wells are producing.

Furthermore, a producer, especially a small producer. needs a steady income from his wells in order to amortize his investment, pay his operating costs and his taxes. In many instances, the steady income from existing production provides the collateral on which a producer borrows money to continue to drill wells to explore for and develop new gas.

The take-or-pay clause is designed to meet all these needs. It provides that the buyer must take a minimum quantity of gas, on a daily, monthly, or annual basis, or if he does not take this quantity of gas he must pay the producer as if he had taken it. This does not mean that the pipeline pays more money for less gas. The reason is that the pipeline has a right to "make up" the deficiencies in takes over a period of years either at no cost or by payment of a small price differential if the price of the gas has increased between the time the payment is made and the gas is taken into the system. Thus, in the normal course of events, the pipeline is able to operate its system with necessary flexibility, increasing or decreasing its takes as demands of its customers vary, because of weather conditions, economic changes, etc. The producer receives a steady minimum income, to amortize his investment, to meet his operating costs and taxes.

Problems are now being experienced by some pipelines because the two objectives of the pipeline purchaser find themselves in conflict with each other. Many pipelines are experiencing a "deliverability surplus" due to the fact that the demands of their customers are less than the pipelines anticipated due to the economic recession and the reduction in fuel oil prices, which compete with gas in many markets. At the same time, these pipelines have a continuing need to buy gas to meet their long-term needs, 5 to 15 years from now. Thus, pipelines are increasingly finding themselves liable under the take-or-pay provisions of their contracts to pay for gas which they cannot currently take into their systems.

This fact is not a cause for panic, or precipitous or ill-considered Congressional action. The operations of the industry and the clause itself will correct this problem, if it is a problem, over a fairly short period of time. This is so, because:

1. The "make-up" provisions of the gas sales contracts will allow the pipelines to receive gas supplies which they have paid for in the future, at a time more convenient to the pipeline.
2. The buying practices of the pipelines in new contracts will reflect the surplus deliverability situation, and will have lower percentage take requirements and more liberal make-up clauses than earlier contracts. In extreme situations, the pipeline may simply suspend new purchases until some of the take-or-pay balances are "worked off."
3. If situations become too extreme, it is quite possible that producers would renegotiate, on an individual basis, these requirements to avoid pipeline hardship.

The Interstate Natural Gas Association of America recently stated in a submission to FERC that take-or-pay clauses "are a useful economic device by which exploration and production risks are reduced through assurances of minimum levels of cash flow. Without take-or-pay clauses, it is logical to assume that producers would insist on higher wellhead prices to compensate for increased risk they would assume. In other words, if producers were legally precluded from obtaining take-or-pay protection, they would probably insist on commensurate protection through some other mechanism such as price."[34]

Much of the criticism of the take-or-pay clause comes about because of the many different prices which natural gas, a fungible and homogeneous commodity, is sold. This is true not because of the contracting practices of producer and pipeline, but because of federal regulation. Prices paid for gas in the various NGPA categories vary widely from 28 cents per MMBtu to over $9. These prices vary between fields, between producers, and between individual wells. It is inevitable in such a system that 28 cent gas will be shut-in (and perhaps paid for) while more expensive gas is purchased by the same pipeline due to contract obligations. This is not done because the pipeline wants to pay more for its gas supply -- on the contrary it

[34] INGAA Submission to FERC in Docket No. RM82-26, Impact of the NGPA on Current and Projected Natural Gas Markets, p. 28.

wants to do just the opposite, in order to conserve its markets, meet regulatory objections, etc. But the pipeline cannot arbitrarily shut-in some fields (because they are high priced, or for any other reason) and produce others. It must meet its contract obligations in each field, and with each different producer.

The solution to the problem is not, as some suggest, to "tinker" with the contracts entered into between the producer and pipeline. Rather it is to abolish, or reduce, the artificial and meaningless price differentials imposed by law and regulation upon gas from varying "vintages" of sources and sellers.

Congress Should Repeal Unnecessary Demand Restraints

The optimum policy package to stimulate efficient production and use of natural gas from the wellhead to burner-tip combines total producer price deregulation with the absence of artificial demand restraints. For this reason, Congress should repeal the Powerplant and Industrial Fuels Act and incremental pricing provisions in Title II of the Natural Gas Policy Act. These discriminatory restraints on gas use frustrate achievement of the best energy supply mix for industrial use and impede the efficient marketing of natural gas. They are the product of the now-discredited theory that domestic natural gas resources are rapidly disappearing, necessitating the allocation of natural gas among prospective users.

Decontrol Increases National Security

In addition to the economic efficiencies which result from a total deregulation of natural gas, American consumers receive another benefit of paramount importance.

The only source of energy for the U.S. market which is capable of very rapid expansion is the importation of additional supplies of oil or gas. If domestic energy supplies are insufficient to meet a rapid increase in demand, our only recourse would be to increase imports of OPEC oil or gas from Canada or Mexico. These supplies are not only incrementally the highest priced, they are also the least secure. On the other hand, if domestic gas supplies are increased, foreign oil imports to this nation will decline because of the increased supply of domestically-produced natural gas which results from the production and conservation response to natural gas decontrol. A lessened dependence upon insecure foreign oil supplies will reduce our vulnerability to an embargo or other foreign oil supply interruption.

Experience under oil decontrol has shown how dramatically American consumers respond to free market pricing, which rewards them for using oil more efficiently. Industrial, commercial and residential consumers make wiser investments and curtail wasteful consumption when it pays to do so -- that is, when the free market provides a dollars and cents return for using our energy supply in the most efficient manner.

A likely result of natural gas decontrol is a reduction in oil imports of one million barrels per day -- about 20% of our current daily volume of oil imports.[35] This results when additional gas supplies "back out" our marginal source of energy -- OPEC oil.

1982 witnessed two shooting wars occurring simultaneously in the Mideast; this is only the most recent evidence of the uncertainty and fragility of our energy supply lines in the area. Natural gas decontrol will permit us to minimize our dependence upon this precarious source of supply while it frees this nation to pursue its national economic and foreign policy objectives without the threat of retributive supply disruptions.

Conclusion

The NGSA firmly believes that the foregoing economic and noneconomic considerations call for the timely replacement of the Natural Gas Policy Act by legislation implementing a phased deregulation of all natural gas prices at the wellhead. Current market conditions, which feature stable or declining alternative fuel prices and excess gas deliverability, suggest that we can now obtain the significant long-term benefits of decontrol with minimal short-term impact. And while its costs have never been less, the case for decontrol has never been stronger, as demonstrated by our testimony and other statements before the Subcommittee. We hope that the Subcommittee will join us in supporting a phased, total decontrol of all natural gas as the policy which best serves the nation's long-term interests.

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[35] Standard Oil Company (Indiana), "Decontrolling Natural Gas Prices: Issues and Analysis," September, 1981, p. 45.

ANSWERS TO SUBCOMMITTEE'S SPECIFIC QUESTIONS:

1. Question: What has been the experience of member companies under NGPA since its passage in 1978? How, if at all, have operations changed since 1978 due to NGPA?

Answer: Our member companies have attempted to adjust their operations to fit the pricing structure under NGPA. Exploration and development activities have been slanted in the direction of those categories where the greatest price incentives were given. This has resulted in less than optimal use of industry resources, as discussed in depth in the testimony. In general, Association members believe that to the extent operations have changed since 1978 that such changes largely represent the impact of increased regulatory requirements imposed by NGPA and accompanying economic distortions.

2. Question: What rate of return do member companies recognize at the current time on gas production activities?

Answer: The profitability of natural gas production varies from well to well and from property to property. A producer evaluates each prospect for exploration capital on the basis of a number of factors, such as: (1) the expected reserves to be discovered; (2) the price those reserves may be sold for over the life of the field; (3) the risk of failure; (4) the dollars placed at risk in making the expenditure. It is therefore impossible, and misleading, to refer to some composite rate of return used by industry, or even by a single company in all instances. The attempt to find an "average" rate of return and apply it industrywide was one of the major failures of regulation under the Natural Gas Act. On the other hand, the studies which have analyzed after the fact the rate of return earned by the producing industry have determined that the industry does not earn a return on its investments which is out of line with other industrial enterprises in the U.S.

One study which proves that gas production under the Natural Gas Act did not receive an excessive rate of return is a study prepared by Robert F. Naul of Texaco USA.[36] This study used a discounted cash flow technique, a method commonly used in industry to evaluate return while giving effect to the time value of money. This study showed that if prices for old interstate gas were increased to approximately $2.75 per MMBtu in January 1983 (the current Section 103 ceiling price), these gas supplies would have received, over the entire productive lives of the fields involved, a rate of return of 12.6% on their rate base. At the prices now authorized by the NGPA this gas is obviously still earning a return less than 12.6%. This rate of return is considerably below the 15% rate of return found appropriate by the Federal Power Commission in the most recent national rate cases.

Another recent study by Washington Analysis Corporation also attempts to estimate an average rate of return received by producers in drilling new gas wells and new oil wells in 1982. The study, assuming only a $29 per barrel oil price in 1982, found a risk-adjusted rate of return of 12.9%. Assuming a 1982 gas price of $3.17 per MMBtu or $18.38 per barrel equivalent, the study found that new natural gas drilling yields a risk-adjusted rate of return of 8.5%, only 2/3 the rate of return received if a decision to drill for oil were made. This indicates that even in the current market situation gas production efforts are less attractive relative to oil.

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[36] Statement of Robert F. Naul in Joint Comments of Indicated Producers in Docket No. RM82-26 before FERC, Volume II, Appendix B.

3. Question: Are member companies having any difficulty marketing gas at the present time?

Answer: "Marketability" of natural gas can refer to two different aspects of natural gas sales. First, one can speak of "marketability" in the short-term sense of deliverability, in which case your question is whether gas takes are down under existing gas contracts. An informal survey of member companies indicates that most companies have experienced a decline in takes from some pipeline buyers in response to current economic conditions.

The second meaning of "marketability" involves long-term considerations of salability of new gas supplies which are brought to the market for the first time. Again, an informal survey of our members suggests that most producers are experiencing difficulties in marketing new gas supplies.

4. Question: If pipeline customers would indicate that gas which they are obligated to purchase is not currently marketable, would member companies be willing to renegotiate contract terms with those purchasers?

Answer: The producers of natural gas have been and continue to be willing to renegotiate a particular contract term with a pipeline or other purchaser. In fact, in recent months producers have renegotiated contracts with pipeline buyers. Producers recognize that a market must exist for the commodity which they produce and offer for sale. Accordingly, buyers and sellers from time to time adjust contract provisions to ensure a market for and the marketability of natural gas.

5. Question: Testimony at previous hearings in this series has indicated that some sectors of the industry do not believe that "market signals" are being transmitted from consumers of natural gas to producers. What are the views of member companies on this assertion?

Answer: "Market signals" are now being transmitted to consumers of natural gas to producers, but in a less than optimum manner. Today, pipeline purchasers are exercising "market-out" clauses in direct response to load losses being experienced by many distribution utilities who find that consumers, particularly large industrial consumers, are switching to alternate fuels rather than pay prices for natural gas that are not competitive with other fuels. Actions taken by buyers, such as the exercise of market-out clauses and renegotiation of contract terms with producers, are the direct result of signals from the marketplace that the current market will not support price levels that make natural gas non-competitive with alternative fuels.

Market signals are also transmitted with the signing of each new contract between producer and pipeline. Recent contracts are reflecting the current deliverability surplus by much more liberal "take" provisions in favor of the pipelines than was the case only a short time ago. Prices for deep gas (below 15,000 ft.) which are currently being contracted for have also declined significantly from their peaks.

6. Question: How far in advance do member companies make decisions regarding investments in new exploration and development projects? How does the current reduction in demand, as well as in prices for deregulated gas, affect exploration and production plans for future years? How do member companies evaluate potential investments in exploration or development projects?

Answer: Although every producer makes investment decisions in light of that producer's individual circumstances, it can be generally stated that time periods in which investment decisions for new exploration and development projects are made range from as much as 10 years in advance of completion to as short a period as two or three days. In any given project a producer must be able to justify to the investors a return that is attractive when compared to other investments. Therefore each project competes for funding with all other projects available to the producer. Producers must balance risk against the potential return on any given investment. The lead time before any return is received on such investment can be as much as 10 to 15 years. In such instances, producers assume that the product produced will command a price which will provide an adequate return on the investment. On the other hand, relatively low risk development drilling in shallow basins can be made within a month or two before drilling commences. Many producers, depending on their circumstances, try to balance some high risk projects with low risk ones. Their business, to be successful, must operate to make sure that there are adequate revenues to support earlier projects and to provide funds for futher investment in new projects.

Changes in circumstances often cause a producer to reassess earlier decisions in light of changed circumstances. For example, many producers have, since decontrol of oil in 1981, opted to drill more oil wells than gas wells; others have altered previously made drilling decisions as a result of signals from the marketplace which indicate a short-term deliverability surplus; and others are proceeding with longer range projects designed to bring gas or oil to market in 5 to 10 years.

There is simply no hard and fast rule that is applicable to all producers and all projects, as circumstances will differ. The factors noted above are generally included in most evaluation processes.

7. Question: If the current cash flow of member companies were increased, would those revenues be used for exploration or development efforts? Would those revenues be used instead for other purposes?

Answer: The increased revenue from natural gas deregulation will be used to allocate additional capital to exploration and production programs aimed at development of new drilling opportunities and additional production from old reservoirs. In fact, oil companies invest more of their earnings in capital expenditures than do other companies. The capital expenditures of oil companies average 1.6 times profits and 83.5% of cash flow.[37] Of this amount 96% in 1978, 89% in 1979 and 95% in 1980 were energy-related.[38] Capital expenditures for exploration, development, and production of oil and natural gas accounted for 57% of total capital outlays of oil companies in 1978, and increased to 67% in both 1979 and 1980. The capital expenditures of non-oil companies averaged only 1.2 times profits and 68.9% of cash flow between 1974 and 1978.[39]

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[37] U.S. Treasury Department testimony before the Energy and Agricultural Taxation Subcommittee of the Senate Finance Committee, May, 1979.

[38] American Petroleum Institute, "What are the latest facts on petroleum industry capital expenditures?" October 7, 1981.

[39] May, 1979 testimony by Treasury Department cited in footnote 37.

8. Question: Are incentive prices required to encourage exploration efforts? Stated another way, if all wellhead prices were decontrolled, what incentive would producers have to engage in exploration projects (which would result in identification of new reserves)?

Answer: Deregulation of the wellhead price of natural gas will allow the marketplace to provide appropriate incentives for exploration efforts. This result is achieved through the following sequence of events: A phased deregulation gradually reduces above-market clearing prices and increases artificially low prices, so that they converge upon the market clearing price. This price reflects the value which consumers place upon natural gas. If additional supplies are desired, the price will rise, furnishing producers additional incentives to explore for natural gas. If the price remains stable in real terms, this indicates market equilibrium, which means that the producer's current level and mix of exploration development and production efforts satisfies consumer desires.

Reliance upon the marketplace results in the efficient and methodical exploration for and production of our natural gas resources. Producers will direct their efforts towards exploration for natural gas which can be produced and marketed for a profit at the prevailing market price. Geologists, geophysicists, and other industry experts will evaluate individual prospects for exploration dollars on the basis of maximizing production and reserves discoveries for each dollar expended (more "bang for the buck"), without having to fix their decisions into the pricing pigeonholes created by the NGPA. Gas which cannot be sold for a profit at that price will not be produced, and producers will not endeavor to discover gas unmarketable at current prices, nor should they, for if consumers had need of more expensive supplies, the market price would increase to elicit them.

Resources expended in the search for and production -- or importation -- of uneconomic gas supplies are unwisely spent. If such gas is successfully marketed, through externally imposed distortions, consumers are penalized to the extent that the price exceeds the value really placed upon the commodity. In short, free-market-generated incentives encourage natural gas producers to perform each function, including exploration, at an optimum level determined by consumer preferences. The market is able to adjust rapidly to changing supply and demand conditions, while a legislative or regulatory framework cannot make these adjustments so timely or efficiently.

Contrast with this NGPA's "incentive" pricing system, which substitutes for consumer preference Washington's notions as to appropriate levels of exploration, development and production. Because it regulates old gas at unrealistically low prices, the NGPA discourages the maximum efficient production of this portion of the resource base, which would otherwise furnish consumers with readily available supplies at prices determined by the price of competing fuels. While it discourages the efficient use of these reserves, NGPA encourages the exploration for and production of other gas supplies which cannot be brought to market at today's prices.

These false economic "incentives" to producers and consumers are the intended result of the NGPA, but they do not make good economic or natural gas policy sense.

The resultant economic inefficiencies in gas production, transmission, distribution and consumption have been cited by nearly all witnesses appearing before the Subcommittee, and are the theme of these hearings--in result, if not intent. In exploration, as in all other aspects of the natural gas business, the public interest is more wisely, efficiently and cost-effectively served by a return to the free market.

9. Question: What is the assessment of member companies of the decrease in drilling efforts for natural gas over recent months? Will this decrease have any significant impact on supplies in the long term or will it simply result in lower drilling costs for those producers who remain active?

Answer: Our member companies believe that drilling efforts have decreased substantially in recent months and expect this decrease to continue over the near term. The precipitous drop in drilling activity which has been observed during the recent past will undoubtedly have a negative effect on both natural gas reserve additions and deliverability.

This decrease in drilling activity will have a significant impact on long-term supplies. All statistics in recent years show that reserves additions per well are declining. In the last few years the decline in productivity per well has been offset by an increase in the number of wells. As the number of wells drilled declines, the impact on long-term supplies, after a short "lag" period, will be significant. It is important to note that even with the record drilling effort of 1981 new discoveries of natural gas continued to lag behind production (17.2 vs. 18.7 Tcf according to a recent EIA release).

Continued increases in the level of exploration and development, together with the economic incentives which generate these programs, will be necessary to develop adequate domestic reserves to support the level of production required to satisfy expected demands. A reduced drilling effort is not consistent with this objective.

There will be some decrease in drilling costs due to competitive conditions in the drilling industry, but such a decrease will be short-lived and will not begin to offset the detrimental effects of a decline in supplies.

10. Question: Based on experience, what do member companies estimate the average wellhead price for gas would be in a totally decontrolled market?

Answer: The Association refrains from citing members' free market price estimates for both practical and legal reasons. First, the free market price of natural gas at the wellhead will be determined by the price of competing fuels, which vary from area to area. Natural gas competes in the marketplace against #6 oil, #2 oil, electricity, coal, wood, nuclear and hydropower, depending upon the application and location. As numerous witnesses before the Subcommittee have pointed out, this means that there are many natural gas "markets," with various market clearing prices. This complexity, of course, lends additional support to our contention that legislative attempts to fix uniform natural gas prices are inappropriate and contrary to the interests of consumers.

Second, as a trade association, NGSA and its member companies are sensitive to antitrust considerations which suggest that the sharing of price information, whether current or projected, is improper. Accordingly, NGSA is precluded from projecting or predicting prices.

11. Question: Are there aspects of Federal pipeline regulation which member companies believe should be changed?

Answer: NGSA feels strongly that the Congress or FERC should not regulate producers' activities, contracts or prices indirectly, through the imposition of requirements on their pipeline purchasers. Section 601 of the NGPA was specifically designed to prevent this type of indirect regulation. Nevertheless, through a distorted interpretation of the "fraud or abuse" exception in Section 601, some distribution companies and consumer groups are attempting to force indirect regulation over deregulated prices and impose restrictions on contracting practices which are beyond the Commission's jurisdiction. Congress should not countenance indirect regulation of producers through improper regulation of pipeline purchasers.

We note that other witnesses have advocated certain changes in pipeline regulation. NGSA's charter limits the Association to advocacy of deregulation of natural gas prices at the wellhead. Accordingly, we have no position or recommendation to offer on the subject of other changes in the type of pipeline regulation. While offering no opinion on the merit of these proposals, NGSA suggests that total wellhead price deregulation be both legislated and implemented before pipeline-related proposals are addressed. Current and past pipeline experiences in an environment of wellhead price regulation may not be replicated when wellhead prices are deregulated. Circumstances may change sufficiently under actual experience with decontrol to render inadvisable measures which appear desirable in today's distorted regulatory environment.

Attention to the problem of achieving total deregulation of the wellhead market, the benefits of which are more fully understood and documented, seems a more appropriate application of Congressional resources at this crucial time.

Attachment 2 to the testimony of Nicholas Bush for the Natural Gas Supply Association.

TAKE-OR-PAY

Just suppose that you own a bakery. You've invested in ovens, signed a lease for a building and hired employees. And suppose somebody offered to have the exclusive right to buy bread from you for 20 years and to pay you the going price for each loaf he bought. There is one little problem: he could give you no assurance that he would buy any particular number of loaves. Would you take his deal?

Of course not.

Just as a baker needs an assured market for his bread in exchange for tying up his output for 20 years, a gas producer needs enough assurance of a steady cash flow to meet his obligations to bankers, suppliers and employees. The mechanism that has evolved to do this is the take-or-pay provisions in gas contracts. Now, take-or-pay provisions have come under heavy attack in some quarters as being "against the public interest" and causing market disordering problems. In reality, the public is well served by these provisions, since they encourage long term stability of supplies and rational price planning and offer a cheaper alternative to storage by pipelines.

Actually, the term "take-or-pay" is misleading; it really should be "take-or-prepay." That is, a prepayment is made today for gas to be delivered later. The make up feature of take-or-pay has been largely ignored in recent discussions of natural gas issues.

In the early years of the gas industry, there was no need for take-or-pay provisions. Gas was a comparatively valueless by-product of oil production, and it was sold whenever a market happened to be available, usually to a nearby gasoline plant. But with the advent of large diameter, long distance pipelines and greater demand for gas, gas itself could be explored for, developed and produced as a valuable commodity. With gas as the major product on a lease, it had to carry the burden of all of the costs of exploration and production; and for this there was a real need for a steady, reliable flow of income to the producer. Take-or-pay was the method which buyers and sellers developed to achieve this.

Next to the pricing provisions, the most important provisions of a gas sales contract are those which specify the quantity of the gas to be purchased. The producer wants to sell his gas as rapidly as his wells will produce it and the pipeline can take the gas into its facilities. Hence, he tries to contract to require the buyer to take as high a percentage of the capacity of his wells to deliver gas as he can. During the shortage period in the late 1970's, pipeline buyers, who needed more gas than they could buy and were curtailing their customers, were willing to sign long-term contracts providing for high percentage "takes" from the producer. In many cases the producers drilled additional wells to enable the gas to be produced at a more rapid rate to meet the urgent pipeline demand.

From the viewpoint of the pipeline, it is desirable to get as many gas reserves contracted to the pipeline as possible in order to protect the long-term supply security of the pipeline and its customers. That need must be considered with -- or balanced against -- the short-term need to meet all the current demands of its customers. Thus, the pipeline buyer must adjust its gas purchase program to continually assure its long-term supply, while at the same time assuring itself that it has enough gas to meet all of its customers' demands, but not too much gas so that it would be found to violate the "take" or quantity provisions of its contracts with its various producers.

The take-or-pay requirements of his contract are the producer's only protection against predatory buying practices of a pipeline, which could, absent this provision, tie up a producer's reserves under a long-term contract and then refuse to permit their production by refusing to take the gas into its system. This was the very practice that the clause was initially designed to prevent. After all, in most cases there are not too many potential buyers close enough to offer to purchase a new gas supply.

It is important to keep in mind that in talking about "producers" or "sellers" we are not talking about a single company or even a small group of companies. Instead, pipelines buy from thousands of producers and have individual contracts with each one. It would not be fair, logical, or "in the public interest" for a pipeline to favor one producer over another, taking one person's gas while leaving another's in the ground. In fact, if two or more producers are selling gas from the same reservoir, the gas will move underground through the rock to the wells which are producing -- and away from wells which are shut-in. This means that the producer whose wells are not producing can actually have his gas drained away by another producer whose wells are producing.

Furthermore, a producer, especially a small producer, needs a steady income from his wells in order to pay his fixed costs, operating costs and taxes. In many instances, the steady income from existing production provides the collateral on which a producer borrows money to continue to drill wells to explore for and develop new gas.

It is assumed that the existence of a take-or-pay provision is solely for the benefit of the seller. But, a buyer has a real interest in keeping an assured supply. Without take-or-pay, long term contracts for gas supplies would be rare, leaving buyers with the inability to finance pipelines and attract markets. And the level of take-or-pay will in part determine the number of wells to be drilled on a lease and the size of surface facilities to be installed, which in turn affect the volume of gas available to the purchaser on any given day.

A take-or-pay provision is designed to meet the needs of both the producer and the pipeline. It provides that the buyer must take a minimum quantity of gas, on a daily, monthly, or annual basis, but, if he does not take this quantity of gas, he must pay the producer as if he had taken it. This does not mean that the pipeline pays more money for less gas. The reason is that the pipeline has a right to "make up" the deficiencies in takes, either at no cost or by payment of a small price differential if the price of the gas has increased between the time the payment is made and the gas is taken into the system. Thus, in the normal course of events, the pipeline is able to operate its system with necessary flexibility, increasing or decreasing its takes as demands of its customers vary, because of weather conditions, economic changes, etc. The producer receives a steady minimum income to meet his operating costs, taxes and other obligations. And the pipeline's customers only see the carrying charges on take-or-pay amounts, not the full amounts paid, in their rates.

We can speculate what the gas industry might be like without take-or-pay provisions. Since take-or-pay is a trade-off for long term commitments, producer/pipeline contracts would be significantly of shorter duration. Surely there would be a major change in pipeline financing, requiring more equity participation, shorter amortization periods and, presumably, higher rates to offset the greater risks of loss of gas supply. Producers could be expected to develop properties more slowly and perhaps to demand higher prices in return for the uncertainties of cash flow. Short-term, spot sales could lead to shortages on one pipeline system with adequate supplies in others. In short, chaos could supplant stability -- and the consumer is the loser.

One of the early methods used to set the amount of take-or-pay was to relate the amount to be taken or prepaid (the daily contract quantity or DCQ) to the amount of original recoverable reserves covered by the contract. Thus, a DCQ of one Mcf per day for each 10,000 Mcf of reserves would theoretically deplete the reserves in about 27 years. The 1:10,000 formula in time gave way to 1:8,000 (22 years) and 1:7,300 (20 years). Other reserve based formulas were used as well.

But problems developed in basing average daily takes on reserves. One was the inexact nature of reserve estimation; engineers of buyers and sellers often disagreed on just what the recoverable reserves were. Sometimes, arbitration was the only way to resolve differences. In any event, having to agree on reserves every year or two resulted in an inefficient use of technical personnel.

Of even greater significance was the need of pipelines, not so much for long-term supplies (which were sorely needed, too), but for gas immediately to serve their markets. But the interstate pipelines, unable to compete for new supplies in price, found they were able to compete by offering higher take-or-pay levels.

What then developed was a switch from reserve-based take-or-pay levels to a method which gave buyers more gas and sellers more cash for development. That was the use of a percentage of daily gas deliverability to establish the DCQ level. Deliverability is easily determined and redetermined by actual tests, not by estimation, an advantage in time and manpower to both buyers and sellers. The actual percentage to be used was negotiated by the parties, and it has varied extensively depending on many factors, including the number of wells to be drilled, the size of optimum surface facilities, the capacity of the buyer's pipeline and the buyer's need for gas. In general, the percentage ranged from a low of 33-1/3% to a high of 90%. The weighted average percentage was probably around 80%. The time over which the take-or-pay obligation was to be met was sometimes a day or a month but most frequently a year. The time for make up also varied, but, since the FPC mandated at least a five-year make up for sales under the Natural Gas Act, the five-year make up term spread to intrastate sales as well. Make up over the remaining term of the contract -- and sometimes beyond that -- was not infrequent, however.

Problems are now being experienced by some pipelines because the two objectives of the pipeline purchaser find themselves in conflict with each other. Many pipelines are experiencing a "deliverability surplus" due to the fact that the demands of their customers are less than the pipelines anticipated due to the economic recession and the reduction in prices of fuel oil, which competes with gas in many markets. At the same time, these pipelines have a continuing need to buy gas to meet their long-term needs, 5 to 15 years from now. Thus, pipelines are increasingly finding themselves potentially liable under the take-or-pay provisions of their contracts to pay for gas which they cannot currently take into their systems.

This fact is not a cause for panic or precipitous or ill-considered Congressional action. The operations of the industry and the clauses themselves will correct this problem, if it is a problem, over a fairly short period of time. This is so, because:

1. The make up provisions of the gas sales contracts will allow the pipelines to receive gas supplies which they have paid for in the future, at a time more convenient to the pipeline.

2. The buying practices of the pipelines in new contracts will reflect the surplus deliverability situation, and the new contracts will have lower percentage take requirements and more liberal make up clauses than earlier contracts. In extreme situations, the pipeline may simply suspend new purchases until some of the take-or-pay balances are made up.

3. If situations become too extreme, producers will renegotiate these requirements on an individual contract basis to avoid pipeline hardship.

4. In any event, any problem that exists will disappear when the nation's economy revives.

Much of the criticism of the take-or-pay clause comes about because of the many different prices at which natural gas, a fungible and homogeneous commodity, is sold. This is true, not because of the contracting practices of producer and pipeline, but because of federal regulation. Prices paid for gas in the various NGPA categories vary widely, from 45 cents per MMBtu to over $9.00. These prices vary between fields, between producers, and between individual wells -- and sometimes even in the same well. It is inevitable in such a system that, at times, some 45 cent gas will be shut-in (and paid for) while more expensive gas is purchased by the same pipeline due to contract obligations and system demands and pressures. This is not done because the pipeline wants to pay more for its gas supply; on the contrary, it wants to do just the opposite in order to conserve its markets, meet regulatory objections, etc. But the pipeline cannot arbitrarily shut-in some fields because they are high priced, or for any other reason and produce others. It must meet its contract obligations in each field with each different producer.

The solution to the problem is not, as some suggest, to "tinker" with a single part of the contracts entered into between the producer and pipeline. Rather it is to abolish, or reduce, the artificial and meaningless price differentials imposed by law and regulation upon gas from varying "vintages," sources and sellers.

Over the years, there have been some suggestions that the use of take-or-pay provisions, freely negotiated to suit the needs of buyers and sellers, was somehow improper. Indeed, the Federal Power Commission twice considered the desirability of take-or-pay provisions. In each case, the FPC concluded that such provisions were necessary in the industry and that the level of take-or-pay was to be best left to the parties to a contract.

Again today, take-or-pay (without mentioning the make up related to it) is being blamed for the perceived ills in gas markets. With demand for gas reduced because of general economic conditions, take-or-pay provisions will work to do exactly what they were designed to accomplish -- they give producers assured cash flows, provide a cheap alternative to storage by pipelines, and provide a cushion of prepaid gas for make up when the pipelines need it.

Notwithstanding contractual take-or-pay obligations, individual sellers are reaching accommodations with their buyers in relaxing those provisions. This is being done in recognition of the unique circumstances in today's marketplace. This is clear evidence that, just as price signals are being received by producers about interfuel competition, demand signals are being read. The free operation of market forces is working -- working far better than a legislative "solution" to a non-existent take-or-pay problem.

Attachment 3 to the testimony of Nicholas Bush for the Natural Gas Supply Association.

INDEFINITE PRICING PROVISIONS IN A GAS SALES CONTRACT

A. Introduction

Indefinite pricing provisions have been an integral part of most gas sales contracts from the inception of the industry. Indefinite pricing clauses provide a mechanism for buyers and sellers to adjust the price of the gas to variations in its market value over the duration of a long-term (15-20 years or more) gas sales contract. Recently these provisions have come under attack.

The rationale for and operation of these diverse contract provisions are not, unfortunately, well understood outside the natural gas industry. It is therefore important to clearly understand:

1. What an indefinite pricing clause is, and why it has long been a standard feature of gas sales contracts.
2. The various types of indefinite pricing clauses in existence and the relative merits and disadvantages of each.
3. The political history of such clauses and the decisions of the United States Supreme Court, Circuit Courts and State Courts interpreting and enforcing such clauses.

B. The Rationale Behind The Indefinite Pricing Clause

With the construction of major interstate pipelines, vast new markets for natural gas were developed. With the increased demand for gas, a very significant change occurred. Contracts for gas were being written for much longer terms than before, often for at least twenty years and sometimes much longer, as in the case of contracts covering the producing life of a property which could last fifty or more years. This change to extremely long-term contracts was necessitated by the need for significant capital to finance these new interstate pipeline systems. To obtain the necessary permits, certificates, and approvals, the FPC (now the FERC), the Securities and Exchange Commission (SEC), and the investment bankers who were providing the money had to be convinced that sufficient volumes of gas were committed to the project to satisfy the pipeline's market demand, amortize its indebtedness, and provide a reasonable expectation of profit. Both the regulatory agencies and the pipeline companies' bond buyers insisted upon firm long-term contracts for established volumes of gas for the full term of the bonded indebtedness. Thus, in order to sell his gas to the burgeoning interstate market, the producer was forced to acquiesce in contracts of long duration.

After the Supreme Court decision in the Sunray case, 1/ the commitment of gas to an interstate pipeline under the Natural Gas Act of 1938 (NGA) became, for practical purposes, a commitment for the life of the reserves, regardless of the term of the contract, as authority was required to be granted by the Federal Power Commission (FPC) under Section 7b of that Act before the "service" could be "abandoned."2/ As the FPC refused, as a matter of practice, to grant such authority until the reserves were depleted, a sale to an interstate pipeline became effectively a sale for the life of the field, even though new contract terms could be negotiated when the term of the contract expired.

Because of the basic requirement for a long-term contract, one of the most important, and most difficult, features of a gas sales contract is the need to arrive at a fair price over the entire term of the contract. Prior to 1950 when gas was a by-product discovered in the search for oil, and was in oversupply, the initial price was very low. The producer was often willing to agree to a low-initial price to encourage the construction of the pipeline to

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1/ Sunray Mid-Continent Oil Co. v. F.P.C., 364 U.S. 137 (1960).

2/ California v. Southland Royalty Co., 436 U.S. 519 (1978).

provide a market for his gas, with "escalation" or price increase provisions to bring the gas price up to its fair market value at some later point in time in the contract period.

It was very difficult (and still is) for the parties to anticipate, at any particular point in time, what the fair market value would be ten to twenty years in the future. "Fixed Escalation" provisions which provided for a fixed amount of increase in the price at periodic intervals proved to be badly off the mark, as demand for natural gas developed rapidly in the 1950's, 1960's and 1970's.

The solution for the problem was the "indefinite" price escalator clause. It attempts to establish the price of gas sold under a contract as nearly as was practical to the current market price of gas in a producing area as reflected by new contracts entered into from time to time. As we shall develop, these clauses had many defects, but they came much closer to reflecting the "market value" of the gas when it was actually produced 3/ than any fixed escalator or fixed price provision. In so doing, the price for gas could be compared not only with the field price for gas but with the price for oil, for products, for coal and for other mineral resources, which are customarily priced at

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3/ Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866 (Tex.1968).

the market value at the time they are produced and delivered, not the market value many years earlier.

A natural gas producer ordinarily obtains a lease to drill on a person's property; this may be an individual, or the state or federal government. In exchange for the lease, the producer is obligated to pay "royalty" to the land owner. Many royalty agreements contain provisions which require that the producer measure his royalty payments based on the "market value" of the gas. "Market value royalty" clauses have resulted in a plethora of litigation over the "market value" of the gas. The result in many cases is a requirement that an effective indefinite pricing clause must be part of the sales contract. For example, under Texas law "market value" is determined for royalty purposes by the prevailing market prices on the date the gas was actually delivered.[4/]

C. Types Of Indefinite Escalation Clauses And Their Relative Merits.

1. The "Favored Nations" Clause

One of the earliest types of indefinite escalation clauses is the "favored nations" clause, which provides that the price under the contract will increase to the price paid by the same buyer in the same market area for gas of

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[4/] Ibid.

comparable quality. The purpose of this clause was to insure that the first sellers of gas in the market area (which could be as small as a single field) received the same price paid by the buyer to other sellers in the same area. This was expanded to a "three-party" favored nations clause, which required an increase in the price to that paid by any buyer in the same market area for comparable gas.

As early as 1960, the FPC and the United States Supreme Court reviewed, and construed as a normal contract provision, a two-party favored nations clause.5/ The Court did not regard the provision as inherently bad or against public policy.

2. Price Redetermination Clauses

A second type of indefinite pricing clause, used in lieu or of in conjunction with the favored nations clause, was the price redetermination clause. This clause simply allowed one party to give notice to the other that he desired to renegotiate the price. A provision which stops there is often not satisfactory from the standpoint of the producer/seller, because at the time the price is renegotiated the parties may no longer be in an equal bargaining position. The field may be partially depleted,

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5/ Texas Gas Transmission Corp. v. Shell Oil Co., 363 U.S. 263 (1960).

and new buyers more difficult to obtain. Moreover, as to interstate sales prior to December 1, 1978, the seller could not sell to another party because of the Sunray decision. Therefore, the clause often set a target for the renegotiations, such as "the market price for gas of comparable quality" in the same market area. Arbitration clauses were often added in case the parties could not agree on what the market price was at the time. Even assuming the parties could agree on the correct "market price" for one negotiation, the price determined becomes increasingly inaccurate over time until the next redetermination is made.

3. Prices Referenced To The Price Of Competitive Fuels.

In theory the correct market price for gas at any point in time should be equivalent to the price which the consumer would have to pay for an alternative fuel if gas were not available. Because of the difficulties above discussed in administering the favored nations and price redetermination clauses -- deciding what gas is "comparable" or what the correct "market value" is -- additional indefinite pricing provisions were sometimes added, either concurrent with or in addition to, the other clauses above discussed. These clauses allowed price increases to the level of the price of crude oil, or No. 6 fuel oil or No. 2 fuel oil or some fraction therefore, in a specific market area. These prices had the advantage of being readily ascertainable, because they are published in industry or governmental periodicals. The primary disadvantage was that such prices reflected only partly, if at all, the costs of transportation and distribution of the gas to the burner tip, which is the actual point of competition with the alternate fuel.

Such clauses also could not reflect the cost of converting energy burning equipment from one fuel to another, which varies widely with the size of the equipment and the end use involved.

4. Pricing Clauses Based On Indices.

A good example of a clause relating price to an index is the inflation adjustment factor which is incorporated into the NGPA ceiling price by Section 101 of the NGPA. This Section is an explicit recognition by Congress that long-term gas prices must be adjusted at least to offset inflation, if the parties are to be treated fairly. The adjustment is made monthly and is based on the Gross National Product Product Implicit Price Deflator.

5. Area Rate Clauses.

This type of clause permits the contract price to change in accordance with variations in a ceiling price prescribed by law or regulation. The FPC in 1960 prohibited the use of indefinite pricing clauses prospectively in contracts for the sale of gas in interstate commerce for resale as a part of its general "price freeze" strategy until area rates could be established.6/

After the issuance of the Permian Basin Area Rate Decision in August 1965, the FPC, permitted the use of provisions which would adjust the price to the ceiling rate established by the Commission for each producing area.7/ Such provisions were known as "area rate clauses," and quickly became standard in all interstate contracts entered into after that date.

The obvious defect in this type of provision is that it is dependent on the existence of a governmentally-determined ceiling price. When price controls are removed, the mechanism to trigger this provision in the future will no longer exist. While a price in effect on the decontrol date should not be rolled-back, such a clause can have no other prospective operation after decontrol.

6. "FERC-Out" Clauses.

Thus far we have discussed indefinite pricing clauses which operate for the benefit of the producer/seller. Gas sales contracts today commonly

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6/ Order No. 232, 25 F.P.C. 379 (1961); Order No. 232-A, 25 F.P.C. 609 (1961); Order No. 242, 27 F.P.C. 339 (1962).

7/ Order No. 329, 36 F.P.C. 925 (1966), incorporated into the Regulations at 18 C.F.R. § 154.93(b-1).

contain two indefinite pricing clauses which operate for the benefit of the buyer. The first of these is a "FERC-out" or "flow-through" clause. It provides in essence that if the FERC or other appropriate governmental agency does not permit the pipeline purchaser to "flow through" the price provided in the gas sales contract to its customers, then the price paid the producer will be reduced by the amount not permitted to be taken into the pipelines' cost base.

7. The "Market-Out" or "Economic Out" Clause.

The basic theory of these clauses is to permit the pipeline to reduce the contract price paid the producer if the pipeline's weighted average cost of purchased gas, plus its transportation costs and return, exceed the market price of alternate fuels in its market area. The clause takes many different forms, varying all the way from unfettered discretion in the pipeline to reduce its price, to specific parameters under which the clause can be invoked coupled with the right in the producer to cancel the contract and resell to other parties utilizing the pipeline buyer's transportation system at standard rates.

D. Are Indefinite Pricing Clauses In The Public Interest? Judicial History Of Issue

From the foregoing discussion it is apparent that indefinite pricing clauses are an indispensable element of a long-term gas contract which commits gas for sale and delivery in future time periods. This is so because the economic conditions which may prevail over the term of such a contract simply cannot be foreseen at the time the contract is entered into. The only real alternative is to abolish the long-term contract, and sell gas on a "spot" or short-term basis, as oil and other commodities are sold. Such an approach would be inconsistent with the desire of the pipelines and their financiers to protect the useful life of their investment in pipelines, and the desire of the end users to dependable "service" and assured gas supplies for the long term.

The view that indefinite pricing clauses somehow are "against the public interest" seems grounded on several false premises such as:

1. The idea that the initial price in a long-term gas sales contract is the only price bargained for by the parties, and that escalation clauses are somehow adverse to the parties' agreement.

A seller bargains for all the pricing clauses in the contract, including the indefinite pricing clauses. If these clauses are deleted or impaired then the parties' bargain is changed in an unfair and one-sided direction.

2. The idea that the initial price has some relationship to the "historic" or "original" cost of the gas to the producer and that increases in the price are not "cost justified."

An attempt to apply a utility-type cost-of-service approach to producer pricing has been a failure and led to the shortages of the 1970's. The "unit cost" of the gas produced from one well can differ dramatically from the unit cost of gas produced from another well and bears no relation to the value of the product sold. Attempts by the FPC to find some correlation, even on a national-average basis, met with total failure.

3. The idea that a gas producer, unlike every other sector of our economy, public or private, should not be allowed to realize the increased value of his assets (gas reserves in place) over time, and that he must pass on this increased value (economic rent) to the gas consumers.

This concept is the father of the inflammatory phrase "windfall profits," which led to the adoption of the multiple vintage pricing system. It currently applies to some 25 different prices to an identical commodity, based on such extraneous circumstances as the date the well was drilled, the date the contract was signed, whether the sale was intrastate or interstate, the size of the producer/seller, whether the well is a new well or a recompletion, etc.

E. Conclusion.

The real reason why indefinite pricing provisions ay be viewed with suspicion by some, is that they operate to produce market prices which those persons regard as "unfair" or "too high" according to their own preconceived notions of price. This view led Judge Brimmer, United States District Judge in Wyoming, to hold that indefinite pricing clauses were invalid as against public policy.[8] The Tenth Circuit reversed, holding that federal public policy as reflected by the NGPA specifically recognized and permitted indefinite pricing clauses to operate up to the maximum rate established in the Act.[9]

A similar result was reached by the Wyoming Supreme Court in Amoco Production Co. v. Stauffer Chemical Co., 612 P.2d 463 (Wyo. 1980). The Court said:

> "Favored nations clauses are a common feature of gas purchase and sale contracts. The nature of the product and its questionable availability engenders reluctance on the part of producers to enter into long term contracts at the price prevailing at the time of contract. Yet purchasers require long term commitments to insure an adequate supply of gas. A two-party favored nations clause provides an increase in price to match any higher price which the purchaser pays to any other seller. A third-party favored nations clause requires the purchase to match any higher price contracted to be paid by any other buyer in the same field or area. . . . Favored nations clauses are recognized by the courts." (673 F.2d. at 327-328).

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[8] Kerr-McGee Corp. v. Northern Utilities, Inc., 500 F.Supp. 624 (D. Wyo. 1980).

[9] Kerr-McGee Corp. v. Northern Utilities, Inc., 673 F.2d 323 (10th Cir. 1982), cert. denied Nov. 8, 1982, 51 USLW 3357.

It seems clear that indefinite pricing clauses have long been, and should continue to be, an integral and inseparable part of any long-term contract for the sale of gas. Such clauses are the only way to equitably provide for the continuing sale of the gas at its approximate market value at the time it is delivered. Cancellation or impairment of such clauses in existing contracts may "trap" the gas committed by such contracts to inequitable sales, but will at the same time prevent the future sale of any uncontracted for gas under long-term contracts. It is this type of short-sighted attempt to "protect" the short-term interest of the "consumer" which has led to the pricing mess we find ourselves in today.

History has demonstrated that attempts to freeze prices, whether directly through the imposition of price controls, or indirectly through the impairment of contract provisions which do not permit market value price increases, is certain to result in disastrous effects on consumers and on the industry that has been built to serve them.

Senator **Domenici**. Thank you very much. I might ask you, Mr. Bush, while you are here, is there any way that your association in conjunction with anyone else could produce evidence for the Committee quickly as to the short-term price impact of the proposed legislation?

Mr. **Bush**. It depends on which particular piece of legislation. We have tried to provide to the committee, Senator, and——

Senator **Domenici**. How about the Eagleton, Danforth, and Kassebaum?

Mr. **Bush**. If you were to——

Senator **Domenici**. I am not asking you to do that now. Obviously, Senator Danforth has information from at least one entity that would indicate that the short-term savings, meaning, February, March, and April, would be far more dramatic than anything the committee has before it from the energy information organization, which is a rather neutral, factfinding group. And I am just wondering, are you the entity that might supply us with comparable information from your standpoint?

Mr. **Bush**. We would surely be happy to submit it to the committee.

Senator **Domenici**. I think it would be most helpful.

Jerome McGrath, Interstate Natural Gas Association of America.

STATEMENT OF JEROME J. McGRATH, PRESIDENT, INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA

Mr. **McGrath**. Mr. Chairman, I am Jerome McGrath. I am president of the Interstate Natural Gas Association of America. As the committee knows, our membership is comprised of virtually all of the major interstate natural gas pipeline companies in the United States and we are pleased to come before the committee today to contribute, if we can, to the discussions of the committee on a very critical problem.

The interstate pipelines have found themselves the subject of much adverse publicity of late and we have a vital stake in the development of a natural gas market that is truly responsive to both, in terms of natural gas supply and consumer demand, and to this end, we are deeply concerned about the adequacy of the NGPA Act as it is now written and the numerous amendments to that act that have been introduced.

But I do certainly want to lend my voice to those of the members of the committee, to the Chairman, and others. And I got a letter from a colleague the other day saying that this is not the time or place to try a quick fix on legislation. I think your analogy of the balloon is very apt. This is a very complicated question and to try to legislate in a crisis atmosphere, we think would have very adverse implications for all of us.

The problems presently facing the industry and the Nation relating to the natural gas pricing, supply and demand are numerous and complex. Certainly, from our industry's point of view, looking back to 1978 when the NGPA was passed, we feel that the NGPA did accomplish a number of its objectives, certainly the supply situation for the interstate markets has improved immeasurably since the pre-1978 era.

However, it has, as time has shown, brought problems along with it and not entirely of the cause of the NGPA.

None of us at that time forecast the deep recession we would be in today, the softening of the market for natural gas, nor did we predict that the price of oil would drop so precipitously as it has in the last say 12 months. Today we find a temporary surplus of supply on our hands and with that surplus in supply we are faced with a declining market for gas.

Now, what is the cause of the surplus? I think it is many fold. Much attention has been given to take-or-pay clauses. I think that is only a factor in the total picture. We have much higher deliverability available to the interstate pipelines particularly in the offshore. We have more gas coming into the interstate market from the intrastate market and you couple this with the declining performance of the economy and we have a glut on our hands. But it is only of temporary over-supply.

I do wish to point out to the committee that while NGPA has helped the short-term, the long-term picture has not improved measurably since 1978.

Senator DOMENICI. Would you make that statement again please?

Mr. MCGRATH. That while the NGPA has contributed significantly to improving the gas supplies, certainly, in the short-term, it has not improved the long-term situation significantly since 1978. Reserve additions have averaged only 64 percent of production for the last 10 years and only 86 percent production for the last 5 years.

Thus, the long-term supply situation, which was a major factor in persuading Congress to vote for the price increases in the NGPA, as I say, has not changed dramatically since the passage of the act. We still need the incentives to go out and explore and develop new reserves of natural gas if this country is truly to achieve its energy independence.

A major cause of the change in the price of natural gas today is the change in the mix of the supply where we are seeing more high-cost gas going into the systems and less low-cost gas. And that too is due primarily to the decline of old gas. If you look at the figures old gas volumes declined by about 9 percent from 1981 to 1982 and that is consistent with the historical average decline of old gas of about 10 percent a year.

New gas volumes, and I am speaking about 102, 103, and 107 gas, have increased and as that mix has changed the price of gas to the consumers has changed.

I want to make it clear that the interstate pipelines make no money on the sale of gas itself. It is the movement of the gas to market, the investment upon which they are allowed to earn a return on that investment, that the pipelines earn their money. It is not on the gas itself. If the price of gas goes down, the price of gas to the consumer will go down. If it goes up at the wellhead, it is passed on, which is the way the system has operated every since the beginning.

We are faced, many of our companies are faced with severe take-or-pay problems. On a national average, however, I think Senator Murkowski's figures were more nearly correct, that in the total picture it has not yet reached major proportions, but it is significant on individual pipeline systems.

Senator **Domenici**. Mr. McGrath, I hate to interrupt, but you have about another minute.

Mr. **McGrath**. Yes, sir. Well, let me say, Mr. Chairman, that the industry is not just sitting idle. There have been numerous attempts at renegotiations of contracts. Reference has been made to the exercise of market-out clauses. Those clauses are of recent vintage. But they have been exercised and the prices on deep gas in many areas have been reduced.

We look forward to working with the committee in reaching a solution to this complicated problem, but we, again, urge the Congress not to try a quick fix in this lameduck session.

[The prepared statement of Mr. McGrath follows:]

STATEMENT OF JEROME J. MCGRATH, PRESIDENT
INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA
BEFORE THE
COMMITTEE ON ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE

DECEMBER 13, 1982

Mr. Chairman and Members of the Committee:

My name is Jerome J. McGrath. I am President of the Interstate Natural Gas Association of America (INGAA), a national trade association whose membership is comprised of virtually all of the major interstate natural gas transmission companies operating in the United States.

INGAA member companies account for over 90% of all natural gas transported and sold in interstate commerce. All of our member companies are subject to the jurisdiction of the Federal Energy Regulatory Commission (FERC) as mandated by the provisions of the Natural Gas Act (15 U.S.C. 717, *et seq.*) (NGA) and the Natural Gas Policy Act (15 U.S.C. 3301, *et seq.*) (NGPA).

I am pleased to appear today on behalf of INGAA. We have testified before this Committee on numerous occasions, including the natural gas hearings conducted earlier this year and in November, 1981. The interstate pipeline industry, which has found itself the subject of much adverse publicity recently, has a vital interest in the development of a natural gas market that is truly responsive both in terms of natural gas supply and consumer demand. To this end we are deeply concerned about the adequacy of the NGPA as well as the numerous proposed amendments to that Act.

At the outset of my testimony, I want to express INGAA's appreciation for the commitment shown by this Committee to keep abreast of developments and trends in natural gas markets, and your determination to fully evaluate the impact of recently proposed piecemeal amendments to the NGPA. As the "Dear

Colleague" letter sent by the Chairman and other Committee members on December 8th stated, the myriad of limited issue amendments:

> "will not provide the relief they promise, and they may have unintended long-term consequences. . . .before we take any legislative action, we must identify precisely the problem we seek to address and fashion a remedy that will clearly achieve the result we seek."

I heartily agree with this statement. The problems presently facing our industry and the Nation relating to natural gas pricing, supply and demand, do not lend themselves to an emotional "quick fix," regardless of how well intended. Before embarking on any legislative remedies, it is imperative that the problems be thoroughly explored and understood. There is simply not time in the lame duck session for the Congress to develop an appropriate record upon which to base comprehensive legislation.

A brief look at the circumstances and events that have gotten us where we are today may be helpful. Moreover, I believe it will further substantiate why a legislative "quick fix" will not work.

The Natural Gas Policy Act of 1978 was the result of a bitter and divisive battle in the Congress over the direction of natural gas pricing policy. While it is easy to criticize the Act, it is also important to recognize that the NGPA was a substantial advance over previous policy in three important respects:

1) the NGPA eliminated the dual market for natural gas, i.e., intrastate versus interstate, that existed prior to enactment, thereby allowing surplus intrastate gas to flow into the gas-short interstate market;

2) the NGPA improved the supply situation by providing incentives for exploration and development of new gas supplies; and,
3) the NGPA clearly established wellhead decontrol as an ultimate goal of Federal policy and provided for a transition from regulation to deregulation.

Since passage of the NGPA, the near-term supply situation has changed from one of shortage to one of surplus. However, this is a surplus of deliverability, rather than conventional domestic long-term supplies which are needed by our industry. Marketing problems and high prices are presently confronting both the interstate natural gas pipeline industry and its consumers. These problems are caused by the rigidity of NGPA pricing provisions which adjust the price of gas upward, but not downward. In addition, the shortages of the 1970's and Federally imposed price controls forced pipelines to negotiate in contract terms rather than price. These contracts, signed in a seller's market, also tend to move gas prices inexorably upwards by making the price controls in the NGPA price floors rather than price ceilings.

The recent concern that gas prices are increasing too rapidly unfortunately has focused on price increases in selected areas of the country and in particular pipeline systems. Little public attention has been given to a national assessment of gas price increases. In the growing public debate over the cause of higher gas prices, a number of misconceptions about the role of interstate pipelines in the gas market have emerged: pipelines are accused of being insensitive to their end-use markets; of deliberately paying too much for gas so that their producer affiliates can profit unduly; and, of behaving anticompetitively. Today, I would like to clarify the reasons for gas price increases and to answer some of the charges which have been made about the pipeline's role in these increases. First, however, I would like to present some background information on the natural gas industry.

THE ROLE OF INTERSTATE PIPELINES IN THE NATURAL GAS MARKET

There are three major segments of the natural gas industry: producers (which explore for and develop natural gas), pipelines (which transport gas from producers to distributors, and in some cases, to end-users), and distributors (which distribute gas to end-users). Currently, the price of gas which a pipeline may pay producers is largely governed by the provisions of the NGPA, with one notable exception. The NGPA deregulated a small quantity of high-cost gas in 1979. Transportation of gas across state lines by interstate pipelines is also regulated by FERC under the NGA. Distribution of gas to end-use customers is regulated by state public utility commissions. Transportation of gas produced and used within a state (intrastate natural gas) is not subject to Federal regulation.

Interstate pipelines are regulated under the Natural Gas Act and do not make money on the buying and selling of natural gas itself. They are allowed to earn a regulated rate of return on the transportation of natural gas. This rate of return is not guaranteed by FERC. If a pipeline transports less gas than it projected in its rate filings in a given year, it will earn less than the allowed rate of return. If a pipeline secures relatively low-cost gas for its customers, the pipeline does not benefit directly from its success. All of the benefits of the low-cost gas are flowed directly through to a pipeline's customers.

Pipelines have both a short and a long-run interest in keeping their purchase gas costs as low as possible. First, once a rate filing is in effect, a pipeline must transport the volume of gas projected in the rate filing in order to make its allowed rate of return. Second, a pipeline's ability to transport gas in the future is dependent on the markets it is authorized by FERC to serve. If prices rise too high, a pipeline's current and future market will decline and it will lose the opportunity to sell its transportation service. Both the physical structure of the pipeline industry and FERC regulation tend to tie pipelines to their existing markets. Thus a pipeline has strong incentives to purchase gas at reasonable prices and to keep its product competitive with alternative fuels.

THE CURRENT STATE OF THE NATURAL GAS MARKET

The current perception is that gas supply is in surplus yet gas prices keep rising. Observers question whether the gas market is workably competitive if gas prices do not fall during an apparent gas "glut."

On the supply side, there is a temporary excess deliverability of natural gas. This short-term surplus has been brought about by three factors:

1) Contracting practices changed during the gas shortages of the 1970's. Minimum deliverabilities under contracts changed from take-or-pay clauses [1] tied to a percentage of the original recoverable reserve (over a 10 to 20 year period) to a take-or-pay clause tied to a very high percentage of daily gas deliverability.

2) high-takes provide incentives for better production techniques and high density drilling. In addition, the NGPA specifically provides incentives for faster production of existing reserves by establishing a higher price for gas from developmental wells (Section 103 gas).

1/ A take-or-pay provision is a minimum requirement to "take" a certain volume of gas (usually expressed as a percent of remaining reserves or of current deliverability) or to pay for gas which is not taken. Usually the contract allows the buyer to receive at a later date gas which is paid for under these provisions.

3) Government policies encourage maximum production from Federal leases especially on the offshore. In the 1970's these policies were designed to help alleviate the shortage problems of interstate pipelines (since offshore gas is dedicated to interstate commerce).

These factors have led to higher-than-expected gas availability at a time when the poor performance of the economy and higher gas prices have led to lower-than-expected demand.

However, the long-term reserve picture has not improved since 1978 when there was a widespread perception of gas shortages. In 1978, the U.S. had 11.1 year supply of gas at 1978 production levels; in 1981, the U.S. had a 10.8 year supply at 1981 production levels. Why then the discrepancy in the short-run and long-run pictures? The answer appears to be that deliverability (both the physical ability of producers to draw down reserves and the contractual obligations of pipelines to take gas quickly) have increased far more rapidly than new reserves have been found. Reserve additions in 1981 actually exceeded gas production (by 2.7 Tcf), leading some to become very optimistic about future gas supplies. But we should not forget that reserve additions have averaged only 64% of production for the last ten years and only 86% of production for the last five years. Thus, the long-term supply situation, which was a major factor in persuading Congress to vote for the price increases in the NGPA, has not changed dramatically since the passage of the Act.

A second major area of confusion is the extent of recent price increases. Media attention has focused on rapid price increases on some pipeline systems in some parts of the country. However, according to the most recent data[2] available from the Energy Information Administration (EIA), average domestic purchased gas costs by interstate pipelines increased by $.34/Mcf (in January, 1982, dollars) or 17% above inflation from mid-1981 to mid-1982. However, the rate of real price change for individual pipelines ranges from a decrease of 2% to an increase of 44%. The media has tended to focus on the pipelines which are experiencing higher-than-average rates of increase, thus distorting perceptions about how quickly gas prices are in fact, rising. However, some of these pipelines with high rates of increase in purchase gas costs still have lower-than-average wellhead costs.

A major cause of the price increase is the shift in volumes from lower-cost NGPA categories to higher-cost NGPA categories. This shift is predominantly due to the natural decline of old gas. For example, old gas volumes (Section 104/106) declined by 9% from mid-1981 to mid-1982. This decline rate is consistent with historical average rates of depletion for existing fields. During the same period, high-cost gas rose slightly in volume (from 4% of interstate purchases to 6%), but rose substantially in contribution to cost (from 12% to 20% of total gas costs). New gas (Sections 102, 103, 108, and 109) maintained their share of costs (50%) and increased slightly their share of volume (33% to 37%).

Some have argued that a major source of interstate price increases is due to a selective cut-back of old gas and increased takes of high-cost gas by interstate pipelines. The EIA data showing that old gas volumes are on average declining at a normal depletion rate demonstrate that this charge is not supportable on an industry-wide basis.

2/ See An Analysis of Post-NGPA Interstate Wellhead Pipeline Purchases, September, 1982, DOE/EIA-0357, Table 1, p. 6.

TAKE-OR-PAY

The contention has been made that much of the interstate price increase is subject to the discretion of natural gas pipelines, who are free to choose among the various sources of gas supply. In fact, pipelines are constrained both by their gas contracts with producers in determining the mix of gas supplies which they take at any point in time, as well as by operational considerations. These "take-or-pay" provisions serve an important function in gas contracting practices: they assure a producer a minimum cash flow and are a fundamental feature of today's long-term contracting practice.

Although there is a widespread impression that take-or-pay clauses are a major contributor to gas price increases, there is no publicly available data on the extent to which such clauses are affecting gas prices today. EIA data suggest that, in fact, the average take-or-pay for high-cost Section 107 gas is lower than the average take-or-pay for lower-cost Section 102 gas.

According to EIA, the average take requirement for Section 107 gas is 75.8% at an average price in mid-1982 of $7.24/Mcf (in January, 1982, dollars), while the average take requirement for offshore Section 102 gas is 90.4% at an average price of $3.20/Mcf. [3] These data suggest that the highest cost gas does not, on average, have the highest take requirements. While it is certainly true that some high-cost gas supplies have high-take requirements, other high-cost gas supplies must have low take requirements in order to produce an average of 75.8%.

Nevertheless, some companies are currently faced with severe take-or-pay problems and it is a matter of great concern to the industry. While

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3/ See Energy Information Administration, Natural Gas Producer/Purchaser Contracts and Their Potential Impacts on The Natural Gas Market, June, 1982, Table 13, p. 41. DOE/EIA-0330 and An Analysis of Post-NGPA Interstate Pipeline Wellhead Purchases, September, 1982, Table 1, p. 6, DOE/EIA-0357.

high-take requirements initially served the interests of both pipelines and producers (pipelines needed the gas to serve their customers and producers were assured a cash flow), the currently soft gas market and unexpected high deliverability has created a take-or-pay problem for some pipelines. In some sense, high-take provisions in many contracts are yet another legacy of NGA price controls and the resulting shortages of the 1970's.

AFFILIATED PRODUCTION

Much attention has been given to the charge that pipelines have been giving preferential treatment to their producer affiliates. I am aware of no evidence which shows that pipelines pay more, on average, to their producer affiliates for gas than to independent producers. As a matter of fact, affiliate production comprises only about 12 percent of total contracted reserves of interstate pipelines.[4] Nor has there been a dramatic increase in pipeline involvement in production activities--pipeline owned reserves accounted for 10% of all contracted reserves in 1975. Finally, the NGPA provides FERC the authority to review the price paid to a producer affiliate to ensure that these prices do not exceed prices paid to non-affiliate producers. Thus, the NGPA provides a check on prices paid to producer affiliates.

COMPETITIVENESS OF THE NATURAL GAS MARKET

Some observers have charged that the current market situation results from the monopsony power of pipelines in the field. This charge ignores the facts. The Federal Trade Commission (FTC), after extensive study, concluded that the wellhead market for natural gas is workably competitive.[5] One only has to look at a pipeline map going into Texas and Louisiana, which jointly produce 70% of U.S. gas supplies, to see that the FTC finding is intuitively correct. While some producers can sell to only a single pipeline, areas with large supply potential are served by multiple lines that compete vigorously with one another to buy gas from producers.

4/ EIA, Gas Supplies of Interstate Natural Gas Pipeline Companies, derived from FERC/FPC Form 15 Filings, DOE/EA-0167.

STATUS OF CONTRACT RENEGOTIATIONS

The industry is not idle in the face of today's market distortions. Most of our companies have been discussing renegotiation of contracts with their producers and as the Committee, I am sure is aware, a number of our companies have invoked market-out clauses in high-cost gas contracts. However, the primary problem with renegotiation relates to the literally thousands of producers, large and small, involved in the process and the difficulty in achieving substantial changes in contract terms of long-standing. While the overall effectiveness of these actions cannot be ascertained at this time, we believe they will produce positive results, at least on some pipeline systems.

CONCLUSION

In summary, the basic cause of gas price increases is the change in mix of gas supplies under the NGPA. This change in mix is predominantly driven by the decline in older, cheaper gas fields. While take-or-pay is a problem for the gas industry, there is no hard evidence today that gas prices would decline substantially if take-or-pay constraints were removed. In fact, available EIA evidence suggest that the highest cost category of gas (Section 107) does not have the highest average take requirements. The charges that gas prices are increasing because the gas market is not competitive or gas pipelines favor affiliated producers are also not supportable. Pipelines are actively meeting with producers to try to renegotiate contracts which do not reflect today's gas market conditions. However, we cannot predict with confidence the outcome of these efforts. Finally, in viewing today's short-term surplus deliverability of natural gas, we should not forget that in 1978 the Nation greatly feared future gas shortages. We must avoid precipitous legislative action which could quickly turn today's surplus into tomorrow's shortage.

5/ Federal Trade Commission, Staff Report of the Bureau of Economics, The Economic Structure and Behavior in the Natural Gas Production Industry, February, 1979, p. 3.

Senator DOMENICI. Mr. McGrath, I wonder if, before we proceed to the next witness, I wonder if you are the proper witness to ask this question, if not, I ask any of you, could you supply it for the record, since the Natural Gas Policy Act was adopted the mix as to the kinds of wells that were drilled by the American industry, independent or otherwise, how many wells were the high-cost incentive gas and how many went to just the new, new gas and how many went for the in-bill, just in those categories.

My hunch is that we got an over-emphasis on the high-cost gas by way of where people put their money, but I don't know that. Would somebody make those numbers available to the committee.

Mr. MCGRATH. I think Mr. Bush's association would be better qualified Interstate Gas on the well drilling.

Senator DOMENICI. Could you have that for us please?

Mr. BUSH. I would be happy to.

Senator DOMENICI. And make it in some way that we understand in terms of as it contributes to the reserves of the country, plus the numbers. I don't know if you have, if it would be possible you might put some average cost in there too. I think there is some average based upon depth, just so we get an idea, if we moved everything in one direction and left another place vacuumed.

The Coalition of Intrastate Pipelines. We have two witnesses, Mr. Terrill and Mr. McLelland. Did you each desire to testify?

Mr. MCLELLAND. Mr. Chairman, I believe in the interest of time, in order to get the second panel on, I will not make a separate statement here.

Senator DOMENICI. Do you have a separate statement?

Mr. MCLELLAND. I would like to submit one.

Senator DOMENICI. We will make that a part of the record.

Mr. Terrill, you may proceed.

[The prepared statement of Mr. McLelland follows:]

TESTIMONY OF STAN McLELLAND
Before Senate Energy & Natural
Resources Committee
December 13, 1982

My name is Stan McLelland, and I am Senior Vice President and General Counsel of Valero Transmission Company, one of the largest intrastate pipelines in the country. I am here with Jim Terrill of L.I.G. representing the Coalition of Intrastate Pipelines, which is an informal group of intrastate pipelines. While our views in many respects are similar, there are some differences due to unique geographical variations, and I will address my remarks from the perspective of the industry in Texas.

Lest anyone should feel that the problems experienced by the intrastate pipelines are purely provincial affecting only a few producing states, I feel it is important to emphasize that the health of the intrastate pipelines and the customers we serve impacts virtually every area of the country. Last year, for example, intrastate pipelines supplied over 35% of the entire industrial requirements for natural gas in this nation. This is particularly true of the agricultural demand for natural gas, including the manufacturing of fertilizers, and the petrochemical industry where approximately 50% of all base petrochemical products in this country were produced with interstate gas. So the continuing health of the intrastate pipeline is not just a regional problem. It affects the economy throughout the nation, and affects the creation or elimination of jobs throughout the country as well.

At the outset, let me emphasize that we in the intrastate pipeline industry have been particularly disadvantaged by the inequities and imperfections built into the Natural Gas Policy Act. Unrealistically high gas prices coupled with excessive take-or-pay provisions bid by interstate pipelines have adversely affected the intrastates and our customers by a diversion of supply away from the intrastate market and by forcing higher prices for the supplies we do obtain. Moreover, because of the preferential treatment which the NGPA gave to the pricing of old gas supplies dedicated to interstate as opposed to intrastate pipelines, the weighted average cost of gas of virtually every intrastate pipeline far exceeds the delivered price of gas of most interstate pipelines. Ironically, those interstate pipelines which have done the most to cause our prices to increase to alarming levels can still, by rolling in the cost of cheap 104 forever regulated gas, deliver gas cheaper than we can. And now, during the recessionary times of reduced demand and overdeliverability, these same interstate pipelines are attempting to take away our historical markets and further exacerbate our problems.

If it sounds as if we believe that the state of the gas industry is in disarray, Mr. Chairman, let me assure you that we do. While there are a number of problems with the NGPA contributing to this situation, it seems that the two receiving the most visibility today are (1) price and (2) take-or-pay.

At the core of the pricing problem is the old cushion of gas dedicated to interstate pipelines which remain forever regulated at prices far below its commodity value. Because they could roll in the cheap cost of this low priced gas, interstate pipelines quickly established buying practices whereby the ceiling on new regulated gas became a floor and the price of deregulated 107 and Canadian import gas seemed not to matter. The sad result of this situation can be seen today when, although virtually all pipelines are experiencing an excess of deliverability, deregulated gas is still selling for as much as $9.00 or more and interstate pipelines are standing in line for permission to import huge amounts of Canadian gas priced at the border at $4.94 -- all at a time when competing fuels such as ethane and low sulfur #6 oil are priced considerably below $5.00. If this doesn't make any sense to you, let me assure you that it doesn't make any sense to me either. Again, Mr. Chairman, let me reiterate that the only way this situation ever developed was the old forever regulated cheap 104 gas cushion. If pipelines don't have artificially low priced cushions to average in, they will not agree to pay more than gas is worth at the wellhead. Without the cushion, I submit there never would have been any $10.00 gas and the price of Canadian gas wouldn't be $4.94.

Given then that this is the current situation, what should be done about it. A price freeze is not the answer because this would merely lock into place the current chaotic situation. Legislatively imposed target prices doesn't work either because the target is constantly moving. Any real solution must involve lifting the price ceiling on old 104 gas which caused the problem. As long as an artificial cushion exists, the price at the wellhead will never reflect the value at the burner tip. Also, I believe that there must be some type of mechanism, such as so-called market out clauses, which permit pipelines to reduce the price being paid for gas which is above market clearing levels and permit even further decreases if market forces demand. I am convinced that free market forces work if they are allowed to operate and in order for them to operate prices must be permitted to come down as well as go up. If some form of these two proposals are implemented together, I believe that order and sanity can once again be restored in the pricing of natural gas and that producers, pipelines, industrial users, and burner tip consumers will all be the beneficiaries.

Very quickly let me also mention the take-or-pay problem. Several proposed solutions have been advanced, ranging from outright abolishment of the provisions to setting a maximum cap on take-or-pay percentages. In that connection, let me suggest that the Texas Railroad Commission has addressed this problem in Texas through a system of statewide proration, requiring equal percentage takes from all sources of supply. This system has worked reasonably well in Texas, and I would recommend that perhaps the Congress review that system to see whether it might make sense on a nationwide basis as well. But I would emphasize that in order for it to have any chance of working, it must be carefully thought out and not some plan thrown together hurriedly.

Mr. Chairman, these two problems discussed are only two of many problems that need to be addressed together by the Congress in attempting to reduce the ills created by the NGPA. The problems of equal access by all pipelines to new supply, off-system sales, the Fuel Use Act, as well as numerous other problems should, we feel, by addressed together if we are ever to develop a sane and sensible natural gas policy in this country which will insure the maximum supplies at the lowest possible price to consumers. Piecemeal solutions and quick fixes are not the answer. The NGPA is a worn out old bald tire. Any attempt to put a patch in one place will simply cause it to blow out somewhere else. What we need is a new tire.

STATEMENT OF J. L. TERRILL, PRESIDENT, LOUISIANA INTRASTATE GAS CORP., ON BEHALF OF THE COALITION OF INTRASTATE PIPELINES, ACCOMPANIED BY STAN McLELLAND, SENIOR VICE PRESIDENT AND GENERAL COUNSEL, VALERO TRANSMISSION CO.

Mr. TERRILL. Thank you, Mr. Chairman. I am J. L. Terrill, president of Louisiana Intrastate Corp. It is the largest independent intrastate pipeline operating in the state of Louisiana and I emphasize independent to distinguish between those pipelines entities who are producer related to operate in some of the producer States and who make direct industrial sales.

Since we appeared before this committee last March, problems caused by the NGPA have become even more apparent, resulting in the introduction of numerous bills, both in the Senate and the House. We would like to demonstrate today that no matter how appealing any of these proposals may appear to be in the short run, unless the NGPA partial decontrol scheme is dismantled and replaced by total decontrol of wellhead prices, the long-term problems of the natural gas industry will not be resolved.

First, we will consider the take-or-pay problem, a relatively new concern resulting from current slack demand. Under the take-or-pay clause, the pipeline must take a certain quantity of gas or pay for it in advance, if not taken until a later date. There is nothing evil about take-or-pay clauses. As pipelines, we bargain for deliverability from the producer causing him to make necessary investments so that maximum volumes of gas we need will be available as our markets require them.

In turn, the producer bargains for a minimum take, so that he will continue to have some cash flow in the form of prepayments if we have to defer taking minimum volumes. In fact, the FEC, now the FERC, has encouraged take-or-pay clauses in regulated contracts.

Within the past few months, because demand is slack, some pipelines have had to make prepayments under take-or-pay clauses. This has resulted in a flurry of bills to fix the problem, ranging from authorizing the FERC after a hearing to modify such contracts to the other extreme of voiding take-or-pay contracts outright.

There is no question but that intrastate pipelines, just as interstate pipelines, could benefit by being relieved of take-or-pay obligations. Our concerns, however, are threefold. First, take-or-pay is not the most important problem facing the natural gas industry. The most serious problem is the Federal price and allocation controls, which have resulted in a cushion of low-price gas on some interstate pipeline systems.

Our second concern is if take-or-pay clauses are outlawed, how are we going to bargain for new gas supplies? What is the quid pro quo for negotiating for deliverability and reserves and long-term contracts from producers, items we must have to assure our customers under our own contracts that we are able to deliver the gas that we have contracted with them to provide?

Third, some of the proposed take-or-pay fixes, Senator Kassebaum's bill in particular, which gives the FERC the discretion to modify take-or-pay, apparently would not apply to intrastate pipelines. It is not equitable with all of the extra penalties we have already seen under the NGPA to treat us any differently than interstate pipelines. Whatever you decide to do on the take-or-pay issue, treat all pipelines alike.

Now, I would like to address the price freeze as proposed by Senators Kassebaum and Eagleton. We are as concerned about escalating natural gas prices as anyone. The problem is that a price freeze locks into law for 2 years the current multitier pricing scheme with aberrationally high and low prices.

The winners under such a scheme continue winning and the losers continue losing. We have a chart here blown up, but it is also attached to my testimony submitted earlier, which I wish to draw your attention to, which illustrates old gas and I want to emphasize old gas. The red line is my company, an intrastate entity. The blue is the interstate pipelines with whom we compete in our State.

A price freeze would lock into law the disadvantages illustrated by this chart. LIG is not atypical according to Foster Associates. Virtually all old intrastate gas in Louisiana is priced under the NGPA at the section 102 new gas prices, which was supposed to be an incentive price.

Deregulated deep gas prices——

Senator **Domenici**. Wait a minute, I can't read the bottom, the percentages. What is under there?

Mr. **Terrill**. The name of the particular pipeline company involved. If you will note, LIG has a 52-percent cushion of, so-called cushion of 105 gas, which is the intrastate equivalent of 104. And it is somewhat higher than some of the other pipelines, but because of the discriminating practice of NGPA in handling even 105 contracts, our price is at the 102 level.

Senator **Domenici**. That does not have anything to do with the fact that you were obtaining more for the old gas before?

Mr. **Terrill**. No, sir. It is the way that the NGPA allows price increases under those existing contracts. It has locked in 104 prices at much lower prices.

Deregulated deep gas prices will not come down to market levels unless and until the low-price gas moves up. A price freeze would prevent this from happening.

We come before this committee with the strong conviction that no Federal wellhead regulation can be flexible enough to respond to changes in the natural gas market. Federal regulation of producer prices does not facilitate adjustments to market conditions up or down. In conjunction with contracting practices, Federal price ceilings have tended to become floors.

In a free market prices fluctuate monthly as market signals are felt by pipelines and producers. And we have another chart, which indicates what happened in the intrastate pipeline business prior to the NGPA passage. This covers the period 1975 to 1978. And it illustrates those contracts which were filed during that period and the prices associated with them.

The black line represents new contracts; the red line represents renegotiated or amended contracts and you will note they go up and down in response to a free natural gas market. The NGPA must be revisited and revised before 1985. Different problems surface with problems or changes in supply and demand and rather than fix any of these temporary problems, we urge you to fix what needs fixing, decontrol oil wellhead prices, defused contract terms tied to artificial above-market prices, equalize access to all supplies of natural gas for all purchasers.

We commend Senator Johnston for proposing a bill which we feel goes to the root of the problem and provides for these changes.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Terrill and Mr. McLelland follows:]

Testimony of

J. L. Terrill and Stan L. McLelland

We appreciate the opportunity to testify today on behalf of the Coalition of Intrastate Pipelines, an ad hoc group formed to represent the interests of some intrastate pipelines, who have been and will continue to be adversely affected by the current federal regulatory controls over natural gas, unless there is a comprehensive revision of the Natural Gas Policy Act (NGPA). 1/

We testified last March before this Committee about those problems: market disorder and the discriminatory treatment against intrastate pipelines by the NGPA with respect to price ceilings, deregulation provisions, and access to supplies. 2/ At that time we endorsed the principles embodied in Senator Johnston's bill, S. 2074, introduced last February. 3/ We steadfastly maintain today that such an approach is the only way to deal with long-term natural gas problems effectively.

Since we last testified, some new problems have been perceived and numerous bills have been introduced which attempt to remedy these perceived problems. Today we appear before you, however, to demonstrate that no matter how appealing these proposals may appear to be in the short-run, they will aggravate our long-term problems and those of the industry as a whole. They are not likely to result in the immediate temporary consumer price relief which has motivated the introduction of such bills. In fact, enactment of some of these proposals may have just the opposite effect by interfering with a renegotiation process that is already occurring throughout the industry, 4/ whereby pipelines and producers are beginning to adjust contracts to reflect current market conditions, i.e., slack demand and market clearing prices on some pipeline systems. In addition, they would create great potential of future supply problems and possible negative consequences that none of us can predict.

Pending legislative proposals in the Senate can be grouped into the following categories: a take-or-pay fix which in some cases also applies to indefinite price escalator clauses (Senators Jepsen, 5/ Kassebaum, 6/ Eagleton, 7/ Danforth, 8/ Specter, 9/ and Chafee, 10/), revision of cost pass-through criteria (Senators Jepsen, 11/ Metzenbaum, 12/ and Kassebaum, 13/), a price freeze (Senators Kassebaum 14/ and Eagleton 15/), and a comprehensive deregulation bill (Senator Johnston, 16/). We will consider the impact of each approach, with the exception of cost pass-through criteria, which do not affect intrastate pipelines.

I. Take-or-Pay

First, consider the take-or-pay problem, a relatively new concern, resulting from current slack demand. Last year the contract problem, for which legislative relief was sought, was indefinite price escalator clauses in combination with most favored nations clauses, which many feared would result in above-market prices in 1985 and beyond. Today the perceived contract problem is take-or-pay.

Under a take-or-pay clause a pipeline must take a certain quantity of gas or pay for it in advance, if not taken until a later date, usually with rights to take those volumes within a five-year period. Take-or-pay clauses vary a great deal. Some specify a percentage to be taken based on deliverability; others are based on an amount which will deplete estimated reserves over a given period of time. While the percentage may stay constant, the actual volume required to be taken may change.

There is nothing pernicious or evil about take-or-pay clauses themselves. As pipelines, we bargain for an assured deliverability from the producer, compelling him by contract to make the necessary investment so that the maximum volumes of gas we need will be available as our markets require them. In turn, the producer bargains for a minimum take, so that he will continue to have some cash flow in the form of pre-payments if we have to defer taking all of the minimum volumes. In fact, the FPC, now the FERC, permitted, even encouraged, take-or-pay clauses on regulated contracts, since those clauses governing deliveries were the only way to assure that necessary volumes were available for sale when required.

Against this background, consider the effect of pending legislative proposals on take-or-pay. Senator Jepsen would provide a rebuttable presumption of abuse if a take-or-pay obligation exceeded 70%, thus jeopardizing pass-through of purchased gas costs. 17/ Senator Kassebaum authorizes FERC to modify take-or-pay obligations, but apparently only for interstate pipelines. 18/ Senator Eagleton and Danforth void them outright with exceptions for special circumstances. 19/ Senator Chafee's bill voids take-or-pay in all contracts, other than for old interstate gas, which commit a purchaser to take delivery of natural gas for a period of more than a year. 20/ Senator Specter, as sponsor of the Northeast Midwest Coalition bill, overrides the obligation by providing a pipeline the right to adjust volumes to come up with the least-cost mix, without penalty. 21/

With respect to the bill submitted by Senator Kassebaum we must respectfully protest the discriminatory treatment. Since it gives FERC the discretion to modify take-or-pay, such discretion may apply only to jurisdictional companies as defined in the Natural Gas Act. 22/ It is not equitable, with all of the extra penalties we already have under the NGPA, to treat us any differently than interstate pipelines. Whatever you decide to do on take-or-pay, treat all pipelines alike. This will be done if all first sales under the NGPA are treated the same.

There is no question that intrastate pipelines, just as interstate pipelines, could benefit by being relieved of certain take-or-pay obligations by not having to raise the money to make the payments. However, if take-or-pay clauses are outlawed, how are we going to be able to bargain for new gas supply? What is the quid pro quo for negotiating an assured deliverability and long-term contract, items we must have to assure our customers under our own long-term contracts that we will be able to deliver the gas we have contracted with them to provide? It is not going to take the producer long to figure out that any agreement we might make to take a minimum amount will be unenforceable, if this legislation stands up. The question then becomes, will there be any new gas supply to purchase. And even if there is, how can we seek the long-term new gas supplies we need to replace our depleting reserves and assure the integrity not only of our gas commitments but also the security of our financial commitments. Once the surplus is exhausted, and it will be as soon as the economy turns around, or later through depletion, what will we do?

Finally, the stated intent of some of these proposals is immediate relief for consumers this winter. Under current regulatory procedures, even if expedited by statute, it is extremely unlikely that contracts could be analyzed and modified, resulting in modification to PGA's and surcharge adjustments, in time to offer relief in January and February when it will be needed the most.

II. A Price Freeze

Senators Kassebaum and Eagleton have proposed a two-year price freeze at October and August maximum lawful prices, respectively. 23/ Deregulated ceiling gas prices are frozen at the contract price for those dates. In addition, both proposals would extend the NGPA partial decontrol schedule by two years. Thus, the winners under the current multi-tiered pricing scheme would continue winning and the losers would continue losing.

There is no question that we could benefit in the short-term from a price freeze, if all this meant was that our purchase prices, primarily for Sections 102 and 105, would stop escalating for two years. But unfortunately there is more to it than that.

We direct your attention to the attached chart, Old Gas Cushions on LIG and Interstate Pipelines Operating in Louisiana. A price freeze would lock into law for two years the disadvantages illustrated by this chart. According to a study of the Louisiana market completed last June by the Foster Associates, Inc., virtually all old intrastate gas is priced at Section 102 new gas levels. 24/ Thus, the red line represented by LIG on the chart is typical of most intrastate pipelines in Louisiana.

A price freeze would cap deregulated prices at abnormally high levels, which is a market we have been priced out of since we have no cushion of cheap gas to average such prices against. It would also keep flowing interstate gas prices too low, ensuring a continuing cushion for some interstate pipelines, and thus allowing above market prices to be bid for high cost gas in new and renegotiated or amended contracts. It would thus lock into law the current aberrational and unfair pricing scheme.

III. Comprehensive Decontrol

We come before this Committee with the strong conviction that no federal wellhead price regulation can be flexible enough to respond to changes in the natural gas market. Federal regulation of producer prices does not facilitate adjustments to market conditions, up or down. In conjunction with contracting practices, federal price ceilings have tended to become floors. In a free market, prices fluctuate monthly, as market signals are felt by pipeline and producer.

We would like to direct your attention to the attached chart, Intrastate Natural Gas Prices Prior to NGPA, a chart which is based on data the producers were required to file with the FPC between the years 1975 and 1978. During those years, prior to the NGPA, intrastate wellhead prices were not regulated. The black line represents new contracts and the red line represents renegotiated or amended contracts. This is a picture of what a free natural gas market looks like. The fluctuations in price are a result of economic incentives or disincentives, and not due to an arbitrary pricing scheme based on drilling date, type of purchaser, type of well, or the accident of the size of a cushion.

We are aware of suggestions that pricing disparities will continue to occur if prices are decontrolled at the wellhead. This is no doubt true, due to various market variables that exist regardless of the NGPA. The point, however, is that the range will not be anywhere near as great as that we have experienced since the NGPA with prices ranging from around $.27/Mcf up to as high as $10.00/Mcf.

In addition, there is no rationale for superimposing an additional layer of pricing differentials set by federal fiat on top of what would already exist under free market conditions, which would not only add to, but skew, the economic signals derived under those free market conditions.

In fact, we believe that even under the NGPA the market has started to respond, albeit with a great deal of difficulty. The GAO report confirms this observation citing the exercise of market-out clauses and the recent decline in deregulated prices as evidence. 25/

Our great fear is that any of the approaches under consideration as described above, will hamper these efforts. If existing contract terms in combination with federal regulation are the problem, does it make sense to prevent renegotiation of those contracts while imposing new, and we believe misguided, federal controls?

The Natural Gas Policy Act must be revised before 1985. We have evidence throughout the country and represented by most all witnesses today that it does not work. Different problems surface with changes in supply and demand. Rather than over-react in the short-run to fix any one of these problems with inflexible regulation, we urge you to fix what needs fixing: decontrol all wellhead prices, defuse contract terms tied to artificial above-market prices, and equalize access to all supplies of natural gas for all consumers. We commend Senator Johnston for proposing a bill which we feel goes to the root of the problem and provides for those changes. To do otherwise is to lurch from short-term fix to short-term fix which will eventually force us back to the central energy problem Congress attempted to address less than five years ago -- an over-regulated market and no gas.

It is our strong hope that the Congress will address natural gas policy comprehensively as soon as possible. The situation continues to grow worse and we strongly believe it will not be remedied by any piecemeal, temporary measures.

FOOTNOTES

1/ 15 U.S.C. §§ 3301-3432 (Supp. 1982).

2/ Testimony of J. L. Terrill and James V. Walzel On Behalf of the Coalition of Intrastate Pipelines, Before the Senate Energy and Natural Resources Committee, March 23, 1982.

3/ S. 2074, 97th Cong., 2d Sess. (1982).

4/ General Accounting Office, Natural Gas Price Increases: A Preliminary Analysis 32-33 (December 9, 1982) [hereinafter cited as GAO Report].

5/ S. 2892, 97th Cong., 2d Sess. (1982).

6/ S. 3054, 97th Cong., 2d Sess. (1982).

7/ Amendment of December 8, 1982 to Danforth bill, S. 3070.

8/ S. 3070, 97th Cong., 2d Sess. (1982).

9/ S. 3076, 97th Cong., 2d Sess. (1982).

10/ S. 3088, 97th Cong., 2d Sess. (1982).

11/ See n. 5 supra.

12/ S. 3028, 97th Cong., 2d Sess. (1982).

13/ See n. 6 supra.

14/ Id.

15/ S. 3069, 97th Cong., 2d Sess. (1982).

16/ See n. 3 supra.

17/ See n. 5 supra.

18/ See n. 6 supra.

19/ See notes 7 and 8 supra.

20/ See n. 10 supra.

21/ See n. 9 supra.

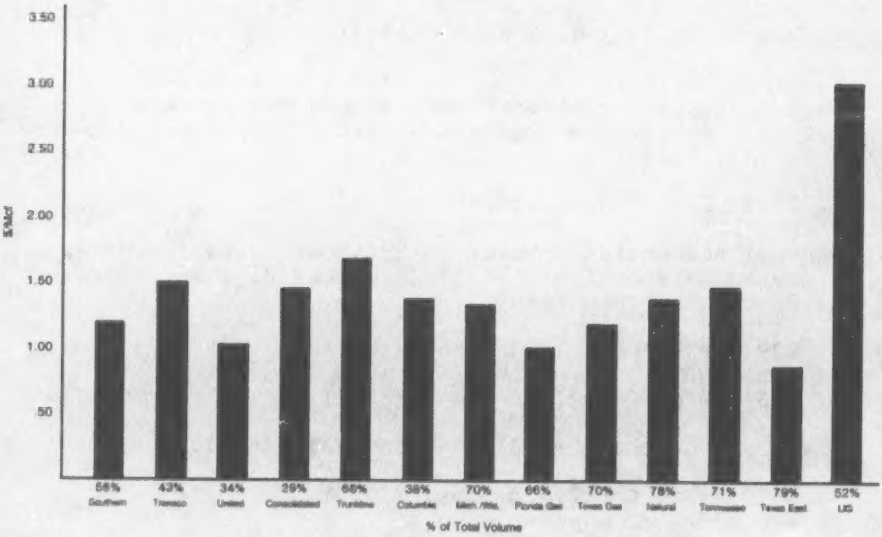
22/ 15 U.S.C. § 717(b) (1976).

23/ See notes 6 and 15 supra.

24/ Foster Associates, Inc., The Impact of the NGPA on Intrastate Markets in Louisiana vii (June 1982), prepared for the Louisiana Office of Conservation.

25/ GAO Report, supra note 4.

Old Gas Cushions on LIG[a] and Interstate Pipelines[b] Operating in Louisiana[c]



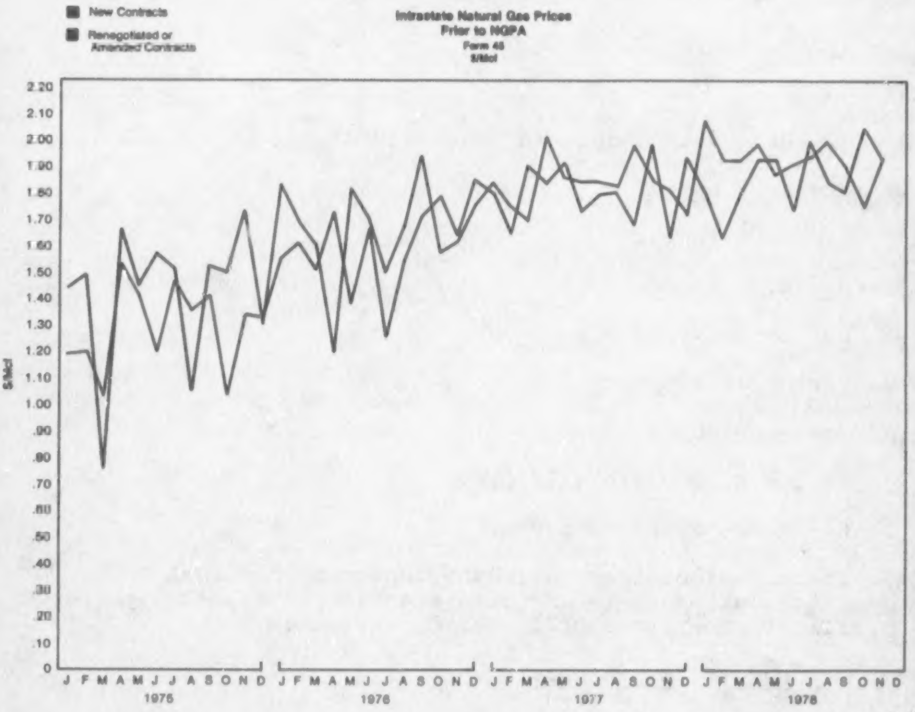
[a] Gas covered by NGPA Sections 105 and 106(b) - (for December 1981)

[b] Gas covered by NGPA Sections 104 and 106(a) - (as of December 1981)

[c] No EIA data available for Ark-La

Source of interstate data: Table 19, The Current State of the Natural Gas Market: An Analysis of the NGPA and Several Alternatives, Part 1, p. 66 (EIA, December 1981)

Intrastate Natural Gas Prices
Prior to NGPA
Form 45
$/Mcf



42%

Senator DOMENICI. Thank you very much, Mr. Terrill.

Our next witness is Mr. Lawrence, president, American Gas Association.

STATEMENT OF GEORGE H. LAWRENCE, PRESIDENT, AMERICAN GAS ASSOCIATION

Mr. LAWRENCE. I am George H. Lawrence, president of the American Gas Association. We commend you, Mr. Chairman and members of the committee, for holding this hearing. Speaking on behalf of AGA, I am pleased to participate.

If we look at the root causes of recent price increases, we find two major factors. First, old and relatively inexpensive gas is being depleted and replaced by newer, more expensive supplies. We cannot do much to reverse the depletion of old gas reserves, but we are having some success in obtaining more reasonable prices for the newer gas that offsets declines in old gas production.

Second, unreasonable take-or-pay for large volumes of expensive gas, whether or not the gas can be resold. As gas demand has dropped because of the recession, conservation and low oil prices, pipelines have responded by reducing their takes to the minimum contract level.

Since the minimum takes for new gas are generally higher than the minimum takes for old gas, the percentage of new, high priced gas in the supply mix is increasing. Because take-or-pay clauses assure producer revenues regardless of whether or not demand exists, producers have little incentive to renegotiate.

Furthermore, because royalty owners and other parties have interests in these contracts, it is difficult for producers to reach a renegotiating position. Thus, a legislative solution is probably necessary.

Another problem that AGA identified almost 2 years, that has been identified here, is the take-or-pay contracts, but we submit to you, Senators, that there can be a solution to this problem, an overall package solution that would address these and other problems that could have broad congressional support, hopefully broad industry and consumer support, that would result in a leveling off of prices in 1983 and an orderly transition into the deregulated fuel market that we all want.

I submit to you that is a challenge that is worthy of consideration of all segments of our industry and that fourth segment that our AGA chairman has referred to, that fourth segment being the consumer. And it is certainly worth the best ebforts of this committee and of Congress.

A fifth point, what can we do now, today, this winter? We submit to you that the answer lies in low-income fuel assistance that has been referred to here several timas. We support the increase up to $2.5 billion. We have supported larger appropriation increases. And another very important point, Senator Warner, I particular call to your attention, because it is coming before the Senate Finance Committee is the fact that we have many of our gas companies that in addition to the Federal fuel assistance, have some of their own self-help programs for the low-income consumer, stockholder money, add more affluent consumer money, combined with Salvation Army and United Way. But private money is going in to help the low-income consumer.

Right now the law prevents the social security recipients from receiving that private sector help without being offset against his social security income. We think that law should be changed. That is what we can do to help the consumer now, this winter and we would support immediate action on that. I don't think that social security point has been made yet in these hearings and I would underline it.

Thank you, Senator.

[The prepared statement of Mr. Lawrence follows:]

Testimony of
George H. Lawrence, President
of the
American Gas Association
before the
Committee on Energy and Natural Resources
of the
U.S. Senate
December 13, 1982

- -

Introduction

Mr. Chairman and Members of the Committee:

I am George H. Lawrence, President of the American Gas Association. A.G.A. is a national trade association, composed of 250 natural gas distribution and transmission companies. These companies serve over 160 million consumers in all 50 states.

We commend you, Mr. Chairman and members of the Committee, for holding this hearing. Speaking on behalf of A.G.A., I am pleased to participate. Our companies are well aware of the growing national concern over the rate of increase in natural gas prices -- and we are pleased that the Committee is providing a forum for this concern.

We know that the price increases forecast for this winter will strain consumer budgets and, in some cases, cause actual hardship. We care about our customers and we want to bring those prices down -- but our options are very limited unless Congress passes legislation to make it possible to renegotiate onerous gas contracts.

If we look at the root causes of recent price increases, we find two major factors. First, old and relatively inexpensive gas is being depleted and replaced by newer, more expensive supplies. We cannot do much to reverse the depletion of old gas reserves but we are having some success in obtaining more reasonable prices for the newer gas that offsets declines in old gas production. Secondly, unreasonable take or pay clauses in contracts for new gas require pipelines to pay for large volumes of expensive gas whether or not the gas can be resold. As gas demand has dropped because of the recession, conservation, and low oil prices, pipelines have responded by reducing their takes to the minimum contract level. Since the minimum takes for new gas are generally higher than the minimum takes for old gas, the percentage of new, high priced gas in the supply mix is increasing. Because take or pay clauses assure producer revenues regardless of whether or not demand exists, producers have little incentive to renegotiate. Furthermore, because royalty owners and other parties have interests in these contracts, it is difficult for producers to reach a renegotiating position. Thus, a legislative solution is probably necessary.

While take or pay clauses are keeping gas prices high, gas demand has fallen. A recent study by A.G.A. indicates that available supply currently exceeds demand by 2.7 Trillion cubic feet or roughly 15% of U.S. annual production. Much of this excess supply is a result of decreased demand due to the recession, conservation, and fuel switching. A.G.A. estimates that in 1981-82 as much as 515 Billion cubic feet in gas sales were lost to oil and oil products.

As prices reached levels at which fuel switching began to occur, market signals began to flow back to producers. It is, therefore, no surprise that pipelines began exercising market out clauses to reduce the price of Section 107 gas. It is our understanding -- although data are not yet available -- that contracts signed in 1982 contain much lower, and more reasonable, take or pay levels. Furthermore, new contracts sometimes set the price of gas below the legal maximum. Thus, 1982 may well be the last year of too rapid wellhead gas price increases.

During the last year we have urged Congress to examine the effects of high take or pay and indefinite escalator clauses in natural gas contracts. In the last several weeks, many people have begun to talk about solutions for rising gas prices this winter and quite a few gas pricing bills have been introduced in the Congress. We do not believe that plans to freeze wellhead prices will help consumers this heating season. Instead, Congress should appropriate low income energy assistance for people who just cannot pay their bills. In the interim, many of our companies have started their own "fuel aid" programs with corporate funds.

Our Companies Are Concerned About Consumer Prices

About 55% of all residences and commercial buildings use natural gas for heating. Since 1978, retail residential rates have approximately doubled. These increases have spurred customer complaints and pressure on legislators to hold down retail gas prices. The best short-term answer to hardship, delinquencies, and disconnections is low income fuel assistance.

At least 20 utility companies have set up energy assistance funds so far. These funds are administered by religious or charitable organizations and are made up of either shareholder money alone, or shareholder money and outside contributions. These matching contributions have come from our companies' pipeline suppliers, from local industry, from gas company employees, and gas consumers. Private fuel assistance funds have raised substantial sums to date, and these funds will continue to grow.

Recently, we learned that disadvantaged people who receive Federal Supplemental Security Income payments and private fuel aid may have their payments decreased by the amount of private fuel aid. We have had extensive conversations with officials at the Department of Health and Human Services and have found that there is very little flexibility allowed under the law for outside payments to SSI recipients. An amendment to the SSI law is necessary to preserve both the full SSI payment and the private fuel aid program.

A.G.A. has been, and continues to be, a strong supporter of financial assistance for those unable to meet their utility bills. Rising fuel costs disproportionately affect low-income households, which spend a far greater percentage of their disposable family income on natural gas than the average

American household. Because all home energy -- natural gas, fuel oil, and electricity -- is becoming more expensive, A.G.A. strongly supports Federal fuel assistance. Without a permanent Federal program, energy costs will cause severe hardship among the disadvantaged members of society. Our member companies are committed to meeting the energy needs of their customers and support full funding for the Federal fuel aid program at the $1.875 billion authorized in the Omnibus Budget Reconciliation Act of 1981.

Recently, Senators Danforth (R-MO) and Eagleton (D-MO) sponsored S. 3071, which would raise the Federal fuel aid authorization to $2.5 billion. In discussing the bill, Senator Eagleton said:

> The existing level was barely adequate -- if it was adequate at all -- last winter. Clearly, with the price of gas increasing as it is, that amount will not be enough this year. I believe that $2.5 billion -- a one-third increase -- would be a more appropriate figure.

Senator Eagleton's bill recognizes that energy prices have risen in the last year and that more fuel assistance may be necessary. We believe that fuel aid is the very best remedy that Congress can pass this session for rising fuel costs this winter.

Action on Gas Contracts Can Provide Long-Term Relief for Consumers

In addition to their voluntary fuel aid programs for consumers, many companies are trying to lower gas prices by renegotiating their gas supply contracts whenever possible. For example, Transco, Michigan Wisconsin Pipeline, Mid-Louisiana Pipeline, United Gas Pipeline, and Tennessee Gas

Transmission companies have publicly announced that they were exercising their market out clauses. Many contracts, however, were signed during, or shortly after, the gas shortages of the mid-1970s. These contracts may not have market out clauses, or the clause may not be exercisable immediately. A study by Decison Analysis Corporation for A.G.A. found that just 15% of all gas supply contracts have a market out clause.

Without a market out clause, a company may find itself bound to a contract with one or more onerous provisions. These are take or pay and escalator clauses. The same Decision Analysis Study found that 96% of all the contracts signed from April 1977 to mid-1981 have one or more indefinite escalator clauses, while only 22% of those contracts have some form of market out clause. Recent analyses by others indicate that nearly all contracts signed in 1982 have market out clauses. Our own analysis shows that indefinite price escalators in 1977-1981 contracts without market outs will raise retail rates substantially between 1984 and 1985, despite market forces.

In the interim, take or pay clauses are compounding the problem of rising prices. Take or pay clauses force the pipeline to pay for gas, whether or not the pipeline can resell it. When gas demand is down -- as it is now because of the recession, conservation, and low residual oil prices -- pipelines naturally scale back their takes to the absolute minimum allowed under each contract. The problem is that new and deep gas contracts tend to have higher minimum takes than comparatively low cost older gas contracts; thus, the pipeline must take a larger percentage of higher cost gas than previously.

Furthermore, some producers have little incentive to renegotiate existing contracts as long as a take or pay clause assures them of adequate revenues. Although pipeline companies are trying to renegotiate their contracts, they lack bargaining power unless they have a usable market out clause. Where buyers and sellers are on an equal footing -- as when they are negotiating new contracts today -- average gas prices are falling. For example, the Federal Energy Regulatory Commission reports that average prices for §107 deep gas are falling. Congress should act next session to restore the balance between producers and pipelines. Only when that balance is restored will normal economic forces bring supply and demand into equilibrium.

Sound legislation should focus on the problem of take or pay and indefinite escalator clauses in pipeline/producer contracts. That legislation should be equitable for all parties.

Take or pay clauses have been discussed extensively by the media and public officials. We realize that this is a difficult issue. At very low takes, producers may not have enough cash flow to cover their costs. On the other hand, very high takes may (a) drain the reservoir too fast and (b) raise consumer prices if less expensive gas is shut-in. Clearly, there is a "zone of reasonableness" for take or pay contracts which is probably somewhere between 50% to 70% of well deliverability.

Indefinite escalator clauses will be a serious problem after decontrol. Oil-indexed and "most favored nation" clauses will raise the price of large volumes of gas. Some oil-indexed clauses, for example, will raise the price of the contract gas to 120% of crude oil. Frankly, we have not yet found a perfect solution to the problem of indefinite escalator clauses, but there are several attractive options. To their credit, some producers themselves have suggested a "cap" on escalator clauses. Naturally, opinions differ on the criteria that should be used to set the "cap". We are not wedded to any particular strategy or solution, but we are willing to work with you, Mr. Chairman and members of the Committee, to solve this problem.

After 28 years of Federal price controls, our industry is just starting to enter a free market. Naturally, there are problems with contracts signed during the period of transition from the Natural Gas Act. Many of these contracts were signed when our companies needed new, long-term supplies during, or in the aftermath of, the winter of 1976-77. Since then we have seen the supply picture turn completely around. We have seen strong increases in drilling and reserve additions.

Now that the supply picture has improved, it is time to remove restraints on industrial gas demand such as incremental pricing and the Fuel Use Act. Removing these restraints will help us reverse the damaging trend in the industrial market of fuel switching from gas to oil. Selling more gas to industrial customers will spread fixed costs and reduce the burden now borne by residential consumers.

Conclusion

If Congress addresses demand restraints and transitional contracts problems early next year, with a strong bipartisan effort, we believe that all parties -- consumers, utilities, pipelines, and producers -- will benefit.

Thank you again for this opportunity to appear before the Committee. I am pleased to answer any questions you may have.

Senator **Domenici**. Thank you, Mr. Lawrence.

Independent Petroleum Association of America, Danny Conklin.

STATEMENT OF DANNY H. CONKLIN, CHAIRMAN, NATURAL GAS COMMITTEE, INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA

Mr. **Conklin**. Thank you, Mr. Chairman. I am a partner in the Philcon Development, in Amarillo, Tex. I am speaking today as chairman of the Natural Gas Committee for the Independent Petroleum Association of America.

As we well know and has been discussed here, we all face a dilemma. Consumers are angry over escalating natural gas prices and demanding that Congress do something. Congress sensing the mood of the country is pondering a whole range of perceived solutions.

Legislation that is introduced to freeze prices has misunderstood the take-or-pay concept. While some believe that these quick fix solutions will benefit the consumers. We are convinced they will only result in new and graver problems. There is a solution, but it is not going to be the haphazard, piecemeal approaches that have been suggested.

The only answer for consumers, pipelines, distributors, and producers is a full and complete decontrol of all natural gas prices at the earliest possible date. While it is true that burner tip prices of natural gas are increasing, the price increases for natural gas are almost half the price of heating oil.

The price of the full decontrolled crude oil in 1981, prices were rising rapidly. Following decontrol, all prices began a steady downward trend. Until natural gas is fully decontrolled, prices will continue to increase with virtually no hope for any moderation.

In short, if Americans are looking for consumer protection, the Natural Gas Policy Act is the worst possible piece of legislation. Producers are also, and when we go in to take-or-pay, Mr. Chairman, producers are voluntarily suggesting the take-or-pay provisions of their individual contracts. Any congressional meataxe approach would make these voluntary actions difficult, if not impossible.

In fact, unless new contract provisions are developed to insure some type of cash flow from new wells, new well drilling would come to a virtual halt. Finally, any move to violently change contracts overnight would cause more bank failures throughout the southwest. As has been referred to this morning, Penn Square Bank failed in Oklahoma because it was over extended in deep gas drilling.

So even if you don't care what happens to the producers holding workmen's contracts, you might think about innocent people who are hurt when a financial institution collapses.

I would submit that I have prepared testimony.

Senator **Domenici**. We will make it a part of the record.

[The prepared statement of Mr. Conklin follows:]

Statement of Danny H. Conklin, Chairman
Natural Gas Committee
Independent Petroleum Association of America
Before the Senate Energy and Natural Resources Committee
December 13, 1982

Mr. Chairman:

My name is Danny Conklin. I am a partner in the Philcon Development Company, a small company located in Amarillo, Texas, engaged primarily in finding and producing natural gas. I am here today in my capacity as chairman of the Natural Gas Committee of the Independent Petroleum Association of America. IPAA is the national Association of nearly 8,000 independent explorer-producers of domestic crude oil and natural gas.

We appreciate the opportunity to be heard today regarding natural gas markets and a variety of proposals designed to provide "quick fixes" to real and perceived problems in the market.

At the outset, let me remind the Committee that producers have been trying over the past couple of years to warn the Congress and the American public of the distortions and possible market disorders we could face unless major changes are made in the Natural Gas Policy Act and the Natural Gas Act.

When I was last before your Committee, on March 23 of this year, I concluded by saying in part "...we would like to caution everyone against lethargy and benign neglect on this issue. Just because the political decision has been made not to address this issue in 1982, we cannot fall into the trap of believing this issue has been resolved. Each month that passes until Congressional action is taken, the problems we have outlined will worsen."

My predecessor, H.E. "Gene" Wright told the Committee on November 6, 1981, that "Unfortunately, the politics of natural gas tempts us to do nothing. Those who remember the NGPA debate are not anxious to return to it. Many suggest we should just wait for January 1, 1985 and see what happens. As producers, we don't believe the "wait and see" option is open. The distortions we have described here today will get only worse."

And on June 9, 1981, Gene concluded a statement to the Committee with "We hope in the not-too-distant future we will be returning to talk to you more specifically on modification and overhaul of national natural gas policy. We believe comprehensive new legislation is needed, and that serious consideration should start this year (1981)."

Yet at those same hearings, and the Committee can check its transcripts, witness after witness who are pushing the panic button for a variety of the emergency measures now before you, were pleading with you to leave NGPA alone - that it was working fine and should not be changed.

Now, a large number of Members of Congress and the media are declaring we have an emergency. Normally, I define an emergency as something that occurs as the result of an accident, an international incident or an Act of God. The so-called emergency we face today comes as the result of none of the above, but as the result of an Act of Congress - the NGPA.

To refresh our memories a bit, let's look at how that Act came into being. Odd as it may seem, it was an outgrowth of the last natural gas "emergency" that Congress tried to solve.

After more than 20 years of rigid wellhead price controls and rising natural gas demand, we began to experience shortages in the early 1970's. As long as it was only business and industry that faced gas curtailments, Congress resisted a policy change. But the winter of 1976-1977 was cold.

Natural gas was curtailed to the place that businesses, schools and public buildings were closed in parts of the country. The electorate, disturbed by job furloughs and school recesses, demanded Congressional action. That action resulted in passage of NGPA. The essence of that Act said, "let's keep as much gas as cheap as we can for the forseeable future, but for imports and exotic new supplies of gas, we're not concerned about price -- supply is paramount."

When new proposals were presented to import Mexican, Canadian, and Middle Eastern gas at two to five times the average cost of domestic natural gas, producers questioned those decisions. We were ignored.

When the new deep gas supplies started to come to market at two to three times the price of other new supplies, we again raised the flag. As businessmen concerned over our burnertip markets, we wondered privately and aloud in Congressional testimony as to whether we could afford those high cost supplies at this time. Again, we were told that producers of cheaper old gas were subsidizing those new gas supplies and the high cost imports and that consumers didn't need to worry -- at least not for now.

In recent months, the impact of those past decisions have started to sink in and there is a backlash. So, as happens all too often, we just simply declare an "emergency" and go out to find people to blame - in this case it's "greedy" producers, "stupid" pipelines and "heartless" distributors.

I contend that it is none of these, but instead is the result of an ill-conceived piece of legislation, based on false premises, called the Natural Gas Policy Act. Congress should not today be abrogating producer contracts and forcing pipelines and distributors to carry on business practices that make no sense -- Congress should be repealing bad legislation.

I do not deny that under NGPA producers have received some new gas prices which have helped stimulate new gas exploration and development. Thank goodness. Had those incentives not been there and had 65,000 new wells not been drilled since 1978, we wouldn't have any gas to speak of left for consumers, let alone any old cheaper gas.

This points to a very important consideration which the Committee must keep in mind when reviewing any legislative proposal now or in the future. That factor is that while we have a temporary surplus of natural gas at this time, it is not a substantial surplus. Therefore, any action which Congress might take which would further depress an already depressed gas drilling industry, could in a few short months lead us back to shortages as bad or worse than were experienced in 1977.

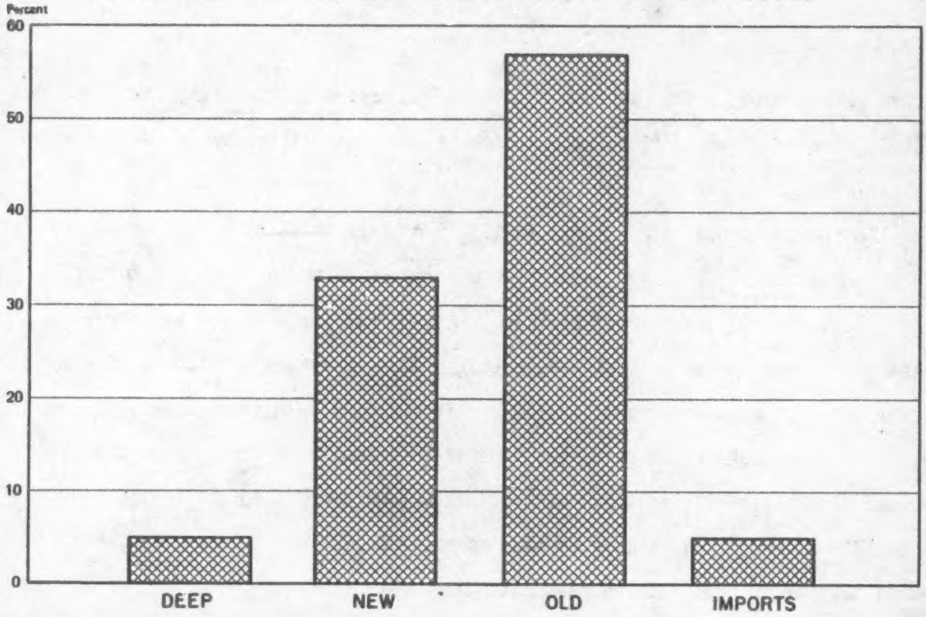
So the Committee might have a feeling for where this issue might take us in the coming months, let us give you our best guess as to where we are today.

. We are consuming about 21 TCF of natural gas per year for all purposes. The two charts on the following page are helpful in seeing the nature of that gas. First, about 55 percent of the gas is old, pre NGPA gas, generally subject to lower NGPA price ceilings. The next largest category is new, price controlled wells drilled since NGPA. That category represents slightly less than 35 percent. The balance is made up about equally by decontrolled, high cost Section 107 gas and imported natural gas and LNG.

The other chart shows the wellhead prices of those categories and compares them to the price of crude oil and the average price of all natural gas. Crude oil currently averages the equivalent of $4.79 per thousand cubic feet of gas. All gas at the wellhead averages $2.29, deep gas is $7.50, new gas $2.86, old gas $1.30 and imports currently work out to $4.95 per thousand cubic feet.

Natural gas is not produced with quality differentials. Every cubic foot has the same intrinsic value. Under NGPA, old gas which is the greatest portion of today's supply, is selling at 17% of the deep gas price, 26% of the average import price, 45% of the new gas price, and only 27% of the energy-equivalent crude oil price. As economists across the Nation have recognized, this great disparity in prices for a multiplicity of natural gas categories (23 in all) causes economic distortions which are raising costs and prices beyond anything which would occur in the absence of NGPA. The only sane long term solution to the problems of consumers and producers is to remove these distorting disparities and restore market disciplines to the production and sale of natural gas as quickly as possible.

SHARE OF U.S. NATURAL GAS CONSUMPTION

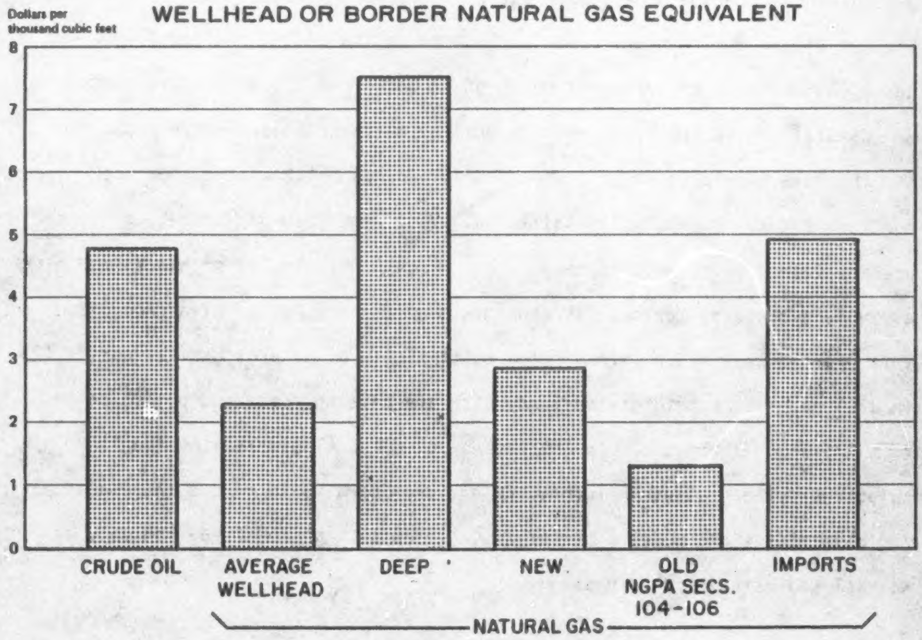


Sources: Energy Information Administration, Oct. 1982. IPAA estimate

IPAA Chart
Dec. 1982

PRICES

WELLHEAD OR BORDER NATURAL GAS EQUIVALENT



Sources: Energy Information Administration, Oct. 1982. IPAA estimate.

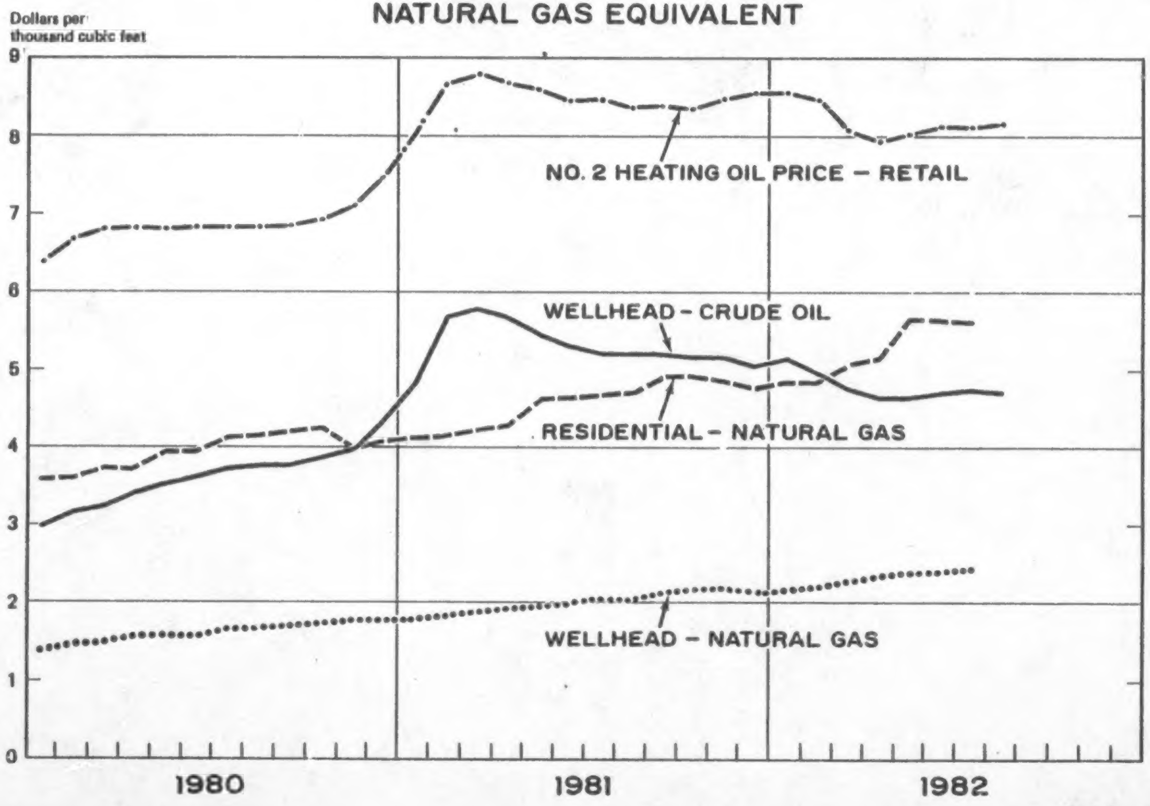
IPAA Chart
Dec. 1982

. The next chart gives us the relationship between the wellhead prices and burnertip prices for natural gas and for crude oil and residential heating oil on a Btu comparative basis. This chart clearly points to the fact that even though burnertip prices of natural gas are increasing on average, those prices remain considerably below heating oil prices.

The other major point made by this chart is what happened to crude oil and heating oil prices before and after decontrol. Leading up to full decontrol of crude oil and products in early 1981, prices were rising rather sharply, only to begin a rather steady downward trend post decontrol. It is our firm conviction that unless and until natural gas is fully decontrolled, we will see nothing but price increases and only in a post decontrol period can we hope for price moderation and decline.

COMPARATIVE PRICES

NATURAL GAS EQUIVALENT



Source: Energy Information Administration

IPAA Chart
Dec. 1982

. While increased wellhead prices have some impact on consumer prices and while the relative pipeline mix of different price categories of natural gas have still further impact in driving prices up, the real culprit is the economy.

No one needs to tell the Committee that industrial plant capacity is way under utilized. As plants and factories curtail their production, their natural gas demand goes down. This leaves the residential user with the problem of paying more and more of the fixed costs of the pipeline and distribution systems. From pipeline to pipeline, this impact varies greatly, depending on each pipelines' mix of consumers and curtailed industries.

. Another major contributing factor to rising consumer prices is the categorical mix of gas a pipeline is buying at any given time. This is a much misunderstood process which has resulted in recent demands that so-called "take or pay" provisions in contracts between pipeline purchasers and producers be nullified. Let me first say, "take-or-pay" is a misleading term. Take-or pay type provisions are not unusual general contract terms in all types of businesses. A better term would be "minimum purchase agreement". A take-or-pay gas contract provision simply guarantees a producer a minimum cash flow from a producing property. If, for example it is estimated that a well is capable of producing 100 units per day, a typical contract would commit the pipeline to a minimum of 80 units -- an 80 percent take or pay. If for a variety of reasons, the pipeline's needs fell below 80 units to say 60 units, it would take delivery of those 60 units, pay for those units and credit the producer's account for an additional 20 units. At the same time, the pipeline's account is credited with 20 units owed it by the producer at some future date when pipeline demand is up.

We don't believe this is unreasonable. In fact, consumers use a form of this in paying their gas bills on average monthly billing plans. Even though a residential consumer may use no gas in July, he pays the same dollars he did in December. Periodically there is an adjustment month when accounts reflecting actual useage and payments are balanced. This helps the cash flow of both distribution companies and consumers. Similar minimum billing procedures exist between distributors and pipelines, guaranteeing cash flow to pipelines to help cover their fixed costs in times of reduced demand.

The so-called take-or-pay problem we now perceive -- that pipelines find themselves actually taking a disproportionate share of high cost gas in favor of acruing "advance payment obligations" on cheaper gas contracts, is solely a function of NGPA. Had it not created the variety of senseless pricing levels that it did, this wouldn't be a problem. Give us a single price for all gas, high or low, and there would be no so-called take-or-pay problem. Obviously, we believe the only way to reach that single price is in the marketplace.

. We don't disagree that some high cost gas prices got out of hand during 1981 and early 1982. But we are not surprised. The NGPA demanded that pipelines secure adequate reserves to avoid future curtailments. In addition, normal market practices dictate that this be done. Obviously, any business seeking new customers must be able to give those customers some guarantee of service. The gas business is no exception.

As old gas supplies are used up, new supplies have to be found. Again, NGPA in effect told us where to get those supplies when it removed deep gas from price controls. It anticipated, when it was passed in 1978, that our gas future was in deep, costly wells. To the extent pipelines weren't able to find enough domestic reserves to satisfy longer term needs, they turned to imports - another more costly than average supply source.

All this has led to demands for quick fixes. Most popular of these seems to be to freeze prices and abrogate take-or-pay contracts. While those fixes may sound helpful to consumers, we see nothing but adverse impacts on them.

First, any price freeze, while freezing low prices from going higher, presumably would freeze high prices so they couldn't go lower. Many contracts, including high cost contracts, have "market out" clauses which allow for the reduction of prices when market conditions change. Those clauses are currently being activated and many contract prices are being reduced.

Likewise, producers are voluntarily adjusting take-or-pay provisions of individual contracts. Any threat of a Congressional "meat-axe" approach to those provisions would almost certainly make voluntary actions more difficult.

If in fact, Congress did take action to abrogate those provisions, it is very likely that unless new contract provisions were developed to assure some type of cash flow from new wells, new well drilling would come to a virtual standstill.

Finally, I would like to warn the Committee of the possible bigger financial implications of some suggested actions. Earlier this year, the Penn Square Bank collapse in Oklahoma shook the banking system throughout the country. A part of its failure can be attributed to an overextension into financing deep gas drilling.

A precipitous move to violently alter those contracts overnight, would, in my opinion, result in several more Penn Squares throughout the Southwest. I alert you to this, because even if you decide you don't care about what happens to producers holding worthless contracts, you might think about innocent people who are hurt when a financial institution collapses.

In conclusion, let me again thank the Committee for its attention. The problems you face have no easy solutions. There is no doubt that gas prices are increasing during a period of surplus. That doesn't make sense and wouldn't occur in a free market. But what we have here is a market which has been subjected to the most counterproductive controls imaginable for more than 28 years. The market that resolves supply-demand imbalances for other commodities can't solve this problem because controls and regulations prevent it from working.

We urge the Committee to counsel with the Administration and others in the Congress and get on with the task as soon as possible to resolve these problems. Be careful. Out of the last gas crisis came NGPA. Let's not make that mistake again. We ask you to again look at the free market for the long term. At least in a free market if prices rise consumers can blame those involved with that market. As long as NGPA type legislation is on the books, consumers are going to continue to take their frustrations out on Members of Congress.

Have a Happy Holiday Season.

Senator **Domenici**. How would the Senators desire to proceed? We have 25 minutes.

Senator **Warner**. We are due to vote in 5.

Senator **Domenici**. I have a number of questions, but I would be prepared to waive mine in the interest of the other panel.

Senator Ford.

Senator **Ford**. I just have one question for Mr. Bush. How do you make up a 100-percent deliverability contract?

Mr. **Bush**. I may not be understanding your question.

Senator **Ford**. As on take-or-pay, you talk about it is very reasonable and that we are perceiving it as something that is really not there and I am just wondering how you make up that hundred percent deliverability contract.

Mr. **Bush**. Senator, without having the facts in front of me, how many hundred percent deliverability contracts are there?

Senator **Ford**. I don't know; I asked you one question. It does not make any difference how many of them are out there, maybe there is only one. There may not be any. I am asking you a question based on your statement.

Mr. **Bush**. I am not sure there are any.

Senator **Ford**. What I want to know is how would you make it up?

Mr. **Bush**. If it would be impossible, I am sure there are none.

Senator **Ford**. Thank you, Mr. Chairman.

Senator **Domenici**. Senator Murkowski.

Senator **Murkowski**. I would like to ask the panel in general if their consensus is if gas is decontrolled or deregulated if they without exception would see the price of gas in average going up?

Mr. **Terrill**. Let me take a shot at it as a pipeline purchaser.

Senator **Murkowski**. I am talking about the overall average price of gas to consumers in this country. We are responding in this hearing obviously to the exceptions that are in existence out there are and causing the consumers hardships.

Mr. **Terrill**. I think there is every likelihood, speaking from the pipeline side, the intrastate pipeline, that the prices could go down, certainly in this period, in this time, because the supply-demand relationship is such that it could for the first time in several years do that. We are in a temporary oversupply situation.

Senator **Murkowski**. So I assume you are prepared to go on record assuming that that will be the case, if gas is deregulated?

Mr. **Terrill**. I can say that I think that would be the case in the short term because of this situation that exists. If we do some things that further aggravate for the longterm the supply/demand relationship, that could turn around very quickly.

Senator **Murkowski**. Are there any members of the panel who take exception to Mr. Terrill's statement?

Mr. **McGrath**. Well, let me, Senator, say that I don't know the answer to your question, but I think that signs we see in the marketplace would suggest that if you are able to renegotiate contracts, and I am not saying you can or cannot, but if you were and you were operating under a deregulated climate, the feeling is that the prices or the contracts would adjust to the forces of the marketplace. But there are a lot of imponderables.

Now, we are under a regulatory atmosphere in the pricing scheme, but there are a lot of imponderables, import oil and everything else.

Senator **Murkowski**. My question was the ultimate response to the consumer, it appears to be the consensus of the panel that the price would go down with deregulation to the consumers.

Mr. **Lawrence**. Senator, we are, at AGA, still in the process of studying this and in the testimony in early January, we will be prepared to get into this in more detail. I think it is a general proposition though that whether by renegotiation voluntarily or whether by some congressional action to defuse take-or-pay on a temporary basis and to defuse the indefinite escalating clauses, that that could slow down an increase, maybe to the point of eliminating an increase in the period of 1983 or 1984.

Senator **Murkowski**. Let me make one observation, the figures that I was given indicated that the shut-in due to take-or-pay is 1 billion cubic feet out of 19 billion cubic consumed daily, so that does not seem to be the problem. The problem we are concerned with, I feel, is the emotional and very real world of the consumer out there, some of which are really faced with some tremendous price increases brought on by what are, in effect, exceptions. And the suggestion was exceptions in the marketplace. How do we address those exceptions? One suggestion has been fuel assistance, which someone has got to pay for. Whether the proponents of that view are suggesting an additional tax, I don't know.

I wonder if the industry would consider renegotiating some of the contracts. I understand the contract with a single Wyoming producer is responsible for a large part of the Missouri price increases. If a pipeline wants to negotiate or renegotiate this, don't you think it would be worth the effort and prudent for the producers to respond?

Mr. **Bush**. Senator, contract negotiations are going on right now between a number of producers and pipelines. They are replete throughout the industry. That is, I think, the summary of why the GAO said on balance there is a great deal of growing evidence that the market is responding to the best of its ability to reduce prices and do away with this excess supply.

But the problem is that there are significant impediments within the NGPA that stand in the way of these contracts being renegotiated. And the key to understanding what is wrong here is that we are not in a deregulated market. Senator Exon went on at some length about the free market not working. There is no free market in natural gas.

Senator **Murkowski**. I understand and I appreciate that.

Mr. **Bush**. And that is the difficulty to the industry here that——

Senator **Murkowski**. The difficulty to the consumer is the exception that exists out there and I am sure you might try to come up with a solution than have this committee or the Government dictate one. I have no further questions.

Mr. **Conklin**. Senator, I personally am involved in several contract renegotiations in regard to take or pay. So, yes, the industry is participating and we are striving to get together without any additional help.

Senator DOMENICI. Senator Warner, do you have any questions?

Senator WARNER. Yes. Mr. Chairman, I would like to pose the question that I did to the panel this morning to Mr. McGrath, on behalf of the pipelines. Of course we are concerned particularly with those in low economic situations who are suffering on the one hand. On the other hand is the private sector. What would the impact be on landowners and gas producers of the readjustment of some of these contracts and other legislative initatives that have been proposed in this Congress?

Could you speak to that issue going from left to right?

Mr. BUSH. I think, Senator, what you said, you have raised an excellent point. There are serious questions of equity involved here on both ends of the spectrum and I don't think anyone in the producing segment or any other segment of the industry is trying to act like we are unsympathetic to problems trying to wrestle with higher prices.

To the extent those prices are caused because of extortion and inequities in the Natural Gas Policy Act, we have been trying to get people's attention to get those addressed. But to go in with a meat axe and simply wholesale abrogate take-or-pay provisions from the contract, leaving a number of producers having unenforceable contracts with all the ramifications that would have in the financial community, investments that have been made in these, it would have a devastating impact. And in the long run and perhaps even in the short term, the person who would suffer the most would be the consumer.

Senator WARNER. Well, it could disrupt your equity base, that is your ability to gain new equity. Your investors, as such, would end up in a situation with a shortness of gas.

Mr. BUSH. Exactly. The supplier would be the first recipient of that distortion and eventually it would work its way to the consumer.

Senator WARNER. Mr. McGrath.

Mr. MCGRATH. Your question, Senator, was on the constitutionality of abrogating a contract.

Senator WARNER. And the impact also on the investment requirements at that end of the pipeline.

Mr. MCGRATH. We are the pipelines in the middle there, so maybe I should skip the answer, but let me say from our point of view on the constitutionality, you can get as many answers, I guess, as you have lawyers looking at it. Being a lawyer myself, I have grave concerns about the constitutionality of it, but it is arguably, I think, constitutional. The problem is you will be in the courthouse for so many years that the consumers who are being hit today will never see the final decision, I don't think.

Mr. TERRILL. I don't think I could add to that, Mr. Warner.

Mr. MCLELLAND. Senator, I am speaking from a little different perspective here, since I represent intrastate a pipeline in Texas, but the Texas Railroad Commission several years ago, back in 1977, when the intrastate pipelines were experiencing an oversupply of gas undertook to issue rules which were subsequently bolstered by statute, which essentially caused proration. It required that pipelines take ratably from all sources of supply.

I realize that is not a very popular notion, certainly among this panel, but it seems to have worked relatively well in Texas. It may not be workable on a national level, but it seems to have worked relatively well.

Mr. LAWRENCE. As to the constitutionality if there is total abrogation and possible confiscation of property, the constitutionality of that would be contested. And we would not support this total abrogation. We think it is a bad step. We think it is a step for the reimposition of controls and we have got a 25-year history that says that does not work.

But we do think there could be some alleviation of the take-or-pay obligations that are causing some dumb things to happen in this industry today. The pipelines do not have the flexibility to buy their cheap source of gas. There could be some alleviation. There could be the defusing of these indefinite escalators and I think there is some unanimity on that and we could get at this orderly transition that we all want, so we don't get back to any question of reimposing controls.

Mr. CONKLIN. Senator, the independent segment uses the take-or-pay clauses as the discipline between pipelines and producers. And, yes, it could affect our, the view of our investors, but primarily I think that we need it, we as producers and they as pipelines, to see that we are not isolated, which it has been worse in that respect.

Senator WARNER. I have just returned from the floor, and it seems to me the likelihood of any legislative guide fixes for problems with the NGPA is remote. If we are to provide any immediate relief, it must be Congress convincing you as an industry to try and renegotiate to the extent possible some of these contracts. The other is pressure must be on FERC to try and use their existing authority to cap off any further increases in prices. Third, we must work to increase the funds available under with the low income assistance program.

I presume that would require a statutory change.

Mr. LAWRENCE. We believe it would; yes.

Senator WARNER. Thank you.

Senator DOMENICI. I have written questions for the four of you, if you would answer them as quickly as possible, I would appreciate it.

Senator, I think we are going to vote. If you want to call the next panel we can try to hear everybody.

Senator WARNER [presiding]. Ladies and gentlemen, I am anxious to go with the next group. Their statements will be put in the record. I ask that we restore order so we can proceed. I will not take the time to introduce the panel before us. I think it is well known to everybody here.

We have the Citizen/Labor Energy Coalition, Mr. Brandon; Associated Gas Distributors, Mr. Schachman; United Distribution Co., Mr. Cooper; Process Gas Consumers, Jack Elam; Petrochemical Energy Group, Mr. Perry.

Gentlemen, I would ask that each of you take about a minute and a half. Your statements in their entirety will be placed in the record. So just give us very briefly your positions and let's start at the left with Mr. Brandon.

STATEMENT OF ROBERT M. BRANDON, EXECUTIVE DIRECTOR, CITIZEN/LABOR ENERGY COALITION

Mr. **Brandon**. Thank you, Senator. In the short period of time allotted us, I will try to give the consumer point of view, which you have heard a little bit about, but nobody has really laid it out.

I think consumers are very concerned that the high prices today demonstrate that there is very little market out there, while there is an oversupply of gas and inexpensive gas is being shut in. I outlined in our testimony some of the causes we feel there are for this problem.

They go beyond the contract problem that was discussed this morning. There are, of course, the take-or-pay contracts which we feel there must be a solution to eliminate the onerous take-or-pay provisions, as well as to eliminate indefinite price escalators in contracts. The studies that have been done show that there is a high level of indefinite price escalators in many of these contracts that would be triggered upon any kind of decontrol in 1985.

And contrary to some of the discussion preceding this panel, there is only limited market-out ability, particularly in these older contracts, which are the ones that have the most onerous provisions.

We also think a cause of the problem is that FERC has allowed rolled in pricing of these high priced contracts, rather than forcing pipelines to be able to market the gas that they contract at a high price for that level.

Fourth, we believe that the PGA process must be reformed, that FERC, we believe, has the authority, but Congress needs to act to make it clear to the Federal Energy Regulatory Commission that PGA's are not automatic passthroughs of cost, that there must be some level of prudence given to contracts, that there presently is no incentive to the pipelines to bargain and that is one of the basic problems.

So there is also no way that the consumer can give a signal back to the marketplace that they won't and can't afford the higher price.

Senator **Warner**. Mr. Brandon, I will have to ask you, out of fairness to the other witnesses present to get their statements in, to pass at this point. You will forgive me. I don't set the rules, but we only have about 8 minutes.

Mr. **Brandon**. Senator, let me just finish quickly by saying that we point out in our testimony that we have a study that shows that there are 300,000 that face having their gas heat shut off this winter, while at the same time about $5 billion of low-cost gas that would provide the relief has been shut in, because of the high-priced gas being delivered in the market.

[The prepared statement of Mr. Brandon follows:]

STATEMENT OF

ROBERT M. BRANDON

Mr. Chairman and Members of the Committee:

My name is Robert M. Brandon, and I am Executive Director of the Citizen/Labor Energy Coalition. The Coalition is a nationwide organization which represents over 300 labor, community, church, farm and senior citizen groups.

Let me first commend the Committee for holding this hearing on how to address the growing crisis of unaffordable gas prices. Natural gas bills hitting consumers this winter are a major cause of concern and alarm in communities through the country. Prices this year are up 25% in Virginia and West Virginia, 21% to 28% in Pennsylvania, 22% in Utah, 60% in some areas of Missouri, 35% in southern California, and 50% in Kansas. Cities like Peoria and Muncie, already devastated by unemployment and recession, are experiencing increases of 50% and 60%. Record numbers of disconnections are occurring as more and more families are unable to meet fuel bills. Families, farmers, businesses, schools, hospitals and others are turning to their local, state and Federal representatives for relief.

What is inexplicable to many consumers is why they are faced with such huge percentage increases in the middle of a glut of natural gas. Demand in the first 8 months of 1982 was down 4.6%, although prices rose 20% from the previous year.[1] According to the September 1982 "Consumption and Expenditures April 1980 through March 1981" report of the Energy Information Administration, "Only natural gas consumption has shown a persistent decline each year." Yet, as individuals struggle to restrain their energy use, (even to the point of reducing household temperatures to dangerously low levels), their efforts are rewarded by larger and larger fuel bills. Those bills are now so high that millions of Americans are unable to purchase even the basic levels of fuel needed.

Most disturbing is that these high prices are not necessary. Hundreds of thousands of households will be shut-off this winter because they cannot pay for high-priced gas while less expensive gas, which they could afford, is being shut in, flared or vented. Gas as low as $.50 per thousand cubic feet (mcf) is going unsold while gas at ten times the price is provided to consumers. Thus, despite a drop in demand and a one to two trillion cubic feet oversupply of gas, consumers are being assaulted by gas bills which many utility executives agree are above sustainable market levels. We calculate that the consumer cost of shut in gas production will be $5 billion this year.

In my testimony, I want to briefly touch on what we perceive are the causes of rising natural gas prices, what effect those prices are having on consumers, and what legislative remedies will be necessary to provide consumers with adequate price protection.

Causes of the problem

Generally, the causes of current natural gas problems can be grouped into two categories: those which are readily identified by most experts, (specifically the so-called contract problem), and those which are just as important contributors to rising prices but are not generally the focus of the recent debate.

Take-or-pay provisions: The take-or-pay clause has become widely-known as a major culprit in the current rounds of gas price increases. While by no means the sole cause, the pipelines' willingness to submit to take-or-pay clauses in long-term contracts provides ample evidence that the natural gas market has been and continues to be a seller's (i.e. producer's) market.

Take-or-pay clauses require the purchaser to take a specified volume of gas or agree to pay a percentage of the cost for the gas not taken. Many contracts put that percentage as high as 80% or 90% of the cost and frequently, the higher percentage contracts are for higher-cost gas, while lower cost supplies have lower take-or-pay requirements.

Consumers are hit twice by these provisions. First, they are effectively paying for gas which they cannot use, (whether demand is down because of efficiency improvements, recessionary impacts or because gas prices are simply too high to afford). Second, the low percentage on old gas means that lower-priced supplies are often shut in while pipelines purchase high-priced supplies.

Perhaps the most well-known example of the consumer problems created by take-or-pay clauses involves the Columbia Gas Transmission Corporation, which serves Kentucky, Maryland, Ohio, Pennsylvania, Virginia, New York, West Virginia, New Jersey and the District of Columbia. In 1981, faced with a surplus of supply, Columbia cut back on its low-cost supplies to a far greater degree than its higher-cost gas. The excuse given was its take-or-pay obligations. The result was that the price of gas, which under normal economic theory should fall in a surplus, increased substantially.

Indefinite escalator clauses: Another example of the strong bargaining position of producers is the prevalence of indefinite price escalator clauses in gas contracts. These contracts, which typically include oil-related price escalators or most-favored nation clauses, create the potential for large producer windfalls upon decontrol, and enormous new costs for local distribution companies and their customers.

According to a study by Decision Analysis Corporation, 67% of the 200 contracts sampled contained indefinite price escalators, which allow producers to raise prices unilaterally upon decontrol to a level defined by factors unaffected by free market forces or costs of production. Over 80% of those clauses were of the most-favored nation variety, tying the post-decontrol price to the highest price charged by any producer in the same area.

The very existence of these contracts is a tribute to the bargaining power of gas producers, and the data indicate that this market power remains strong. The same study found that of the producer/pipeline contracts signed since April 20, 1977, over 96% have indefinite escalator clauses. It has only been very recently that pipelines have begun to exercise more caution in agreeing to such terms, but the fact remains that the vast majority of gas continues to be governed by those imprudent contract terms.

Congress did not contemplate these specific contract problems when it drafted the NGPA, but it did expect the FERC in its role as implemented of the legislation to prevent contracts with such a destablizing effect. The NGPA never altered the FERC's authority under the NGA to regulate pipelines and to insure the contract terms are in the public interest. But the FERC has done nothing to discourage pipelines from signing such contracts. As a result, millions of consumers could not be on the receiving end of excessive and sudden price increases upon decontrol.

FERC's allowance of rolled-in pricing: As a result of the NGPA's policy of maintaining controls on old gas and providing gradual decontrol of new gas, disparities will inevitably exist among different pipelines' average costs of purchased gas. But the FERC exacerbates this problem with its rolled-in pricing policies. By allowing pipelines with supplies of old gas to buy supplies of high-cost gas at prices exceeding market levels, and then to hide the cost of this imprudent purchase in the average cost for all its purchased gas, the FERC has created unnecessary disparities among the pipelines' bidding capacities and allowed higher than warranted marginal prices for gas.

There are numerous examples of pipelines contracting for unnecessarily expensive gas supplies. For example, Colorado Interstate Gas purchased large amounts of high-cost gas from depths below 15,000 feet. The state of Texas, concerned about the impact on its farmers and other users, attempted to prohibit the pass-through of this high-cost deregulated gas but its efforts were overturned on April 7, 1982 by a FERC administrative law judge ruling. Similarly, in late June, the FERC failed to act in two purchased gas adjustment (PGA) cases involving Tennessee GAs Pipeline and United Gas Pipeline, forcing the issue into the courts.

Obviously, the prices being charged for Section 107 gas are far higher than the levels anticipated by the drafters of the NGPA, who, while concerned that adequate incentives be provided, were certainly not anticipating the current amount of abuse.

Purchased Gas Adjustments: The FERC's failure to review PGAs is another cause for spiralling prices and provides a prime example of the Commission's failure to interpret the NGPA to the consumer's benefit. Knowing that there will be no careful scrutiny of their purchase decisions, there is little incentive for pipelines to enter into tough negotiations, particularly when faced with a seller-dominated market. By interpreting the Section 601 "fraud, abuse or similar grounds" standard in its narrowest possible construction, the FERC has placed already captive consumers in an even more vulnerable position.

In September, the Citizen/Labor Energy Coalition investigated the consumer impact from PGAs filed by 16 major interstate pipelines scheduled to take effect on July 1, August 1, September 1 and October 1. Those filings alone will cost gas users over $2 billion. The biggest impacts are felt in California ($264.4 million), Ohio ($246.3 million), Pennsylvania ($153.4 million), and New York ($141.3 million). The regional impacts are as follows: New England ($52.3 million), Mid-Atlantic ($367.6 million), East North Central ($446.2 million) and South Atlantic ($176.5 million). The average household consumer will pay an additional $50 over the relevent six-month period.

Since our study, there have been additional PGA rate filings which will add even more of a price burden to financially-pressed gas users. For example, the latest request of the Tennessee Gas Pipeline, which serves consumers in the Northeast, Midwest and parts of the South, will means extra costs of $215 million.

NGPA Ceilings and Escalators: When Congress passed the Natural Gas Policy Act of 1978, it established a set of ceiling prices which were intended to be just that: ceilings and not floors. The prices were not based on a cost-based methodology nor were they expected to reflect real market levels at any particular point in time. It was fully anticipated that lower than ceiling prices could occur, whether through the states' statutory authority to set lower ceilings or through individual producer/pipeline purchase agreements.

The result of the NGPA, however, has been that maximum price levels have acted both as ceilings and as floors. During the hearings of the House Fossil and Synthetic Fuels Subcommittee last summer, producers testified as to their determination to price at the ceiling levels, despite the resultant unmarketability of such gas at the end user level. Moreover, since the average wellhead price has been substantially higher than estimated at the time of the NGPA passage,[3] producer adherence to the maximum ceiling prices has resulted in bloated consumer bills.

Despite the evidence that prices have exceeded market-clearing levels, the ceilings continue to escalate under the NGPA. Prices inexorably rise in defiance of the market, cost of production, or consumers' ability to pay. Clearly, the possibility of natural gas prices surging ahead of No. 6 or No. 2 oil in some cases was not a major point of discussion during the NGPA conference. Yet, that situation has occurred and must be addressed by amending the NGPA to reduce ceiling prices and slow their escalation.[4]

FERC's actions to raise prices: Gas consumers have been harmed not only by the FERC's failure to implement the Natural Gas Act and the NGPA properly, but by the Commission's numerous decisions to add to the gas pricing burden. While there have been many Commission actions since the passage of the NGPA which have had the result of increasing gas prices, it is only necessary to highlight a few in order to demonstrate how the Commission's actions have shifted billions of dollars from consumers to producers over and above the anticipated revenues provided by Congress within the NGPA.

Included among the Commission actions which have enabled gas producers to obtain higher wellhead prices are:

- —The decision to allow producers to obtain NGPA prices under "area rate clause" provisions in pipeline/producer contracts. While the Commission itself never investigated the economic fallout of its decision, most estimates suggest the consumer impact ranges between $5 and $10 billion. It is interesting to note that while the Commission found no reason to protect interstate users from the effect of allowing area rate clauses to drive contract prices to the higher NGPA rates, the producing states of Kansas and Oklahoma both passed laws prohibiting the triggering of such clauses in intrastate contracts.
- —The decision to allow gas produced from "tight formations" to receive 200% of the Section 103 price. In making its decision to allow producers to receive this above market-clearing price, the Commission neither demanded nor provided actual cost information to justify "incentive" pricing.
- —The decision to expand the definition (beyond the definition expressly set forth in the NGPA) of stripper well natural gas.
- —The decision permitting producers to obtain a higher wellhead price retroactive to December 1, 1978 based upon a change in measuring Btu content
- —The decision to allow pipelines to collect NGPA rates for pipeline produced gas

In addition to the decisions already taken, the FERC has gone even further in its proposals to price gas produced inoffshore waters in depths greater than 300 feet to be priced at 200% of the Section 103 price, to allow gas produced from depths between 10,000 and 15,000 feet to receive 150% of the Section 103 price and to increase the price of old gas. Once again, those proposals were not based on actual cost data nor did they consider the severe consumer impacts or market disordering effects. The Citizen/Labor Energy Coalition estimated that the cost of the "near deep" proposal would be $9 billion over a three year period and that the old gas proposal could cost consumers between $21 billion and $48 billion depending on the level of the new ceiling price selected by the Commission.

The shut-in problem: The bitter irony of the current pricing problems is that as consumers find it harder and harder to cope with rising fuel bills, they are well aware that cheaper gas is available but that it is not being produced.

Consider for instance the case of gas consumers in Ohio, confronting $246 million in increased costs this year. At the same time that 60,000 gas consumers have been disconnected for not paying their bills, small well owners are burning off or venting gas. According to one well owner, enough gas has been vented in his own area to heat several towns.[5] Those small well owners are willing to sell their gas for $3.00 per mcf, but Columbia Pipeline is not willing to buy it. Instead, Columbia has signed a long-term contract with producers in Texas and Louisiana to purchase gas at $8.00 per mcf.

Or take the case of southern California gas users, whose bills are expected to rise 35% this year. The El Paso pipeline is buying gas at $8.00 per mcf, (and paying its own producing affiliate $10.35 for some supplies), while refusing to purchase gas at $2 to $3 per mcf from small producers in New Mexico.[6]

Looking at information on gas purchases by a number of major pipelines furnishes additional evidence that, as pipelines neglect lower-cost gas in favor of higher-cost supplies, consumer costs are affected significantly. We looked at four pipelines -- Columbia, El Paso, Tennessee and Cities Services -- which have filed substantial PGA rate increases over the last year. Table A shows a consistent pattern exists for those companies. There have been significant reductions in lower priced "old" and/or "new" gas supplies and large increases in much higher priced Section 107 supplies. Because the declines in the purchase of lower-priced supplies cannot be explained on the basis of natural well production declines, it must be assumed, (particularly given the statements of small producers in this regard), that large volumes of natural gas from lower-priced categories are simply not being produced. We estimate that the annual cost of this shutting in of lower-priced gas supplies and the meeting of demand with Section 107 or high-priced imports is $5 billion. Based on data contained in the September 1982 Energy Information Administration report, "An Analysis of Post-NGPA Interstate Pipeline Wellhead Purchases," the weighted average price of Sections 102, 103 and 104 gas is $1.97 per mcf, as compared to $7.24 for Section 107 gas. If the 664 billion cubic feet of Section 107 gas had been replaced by an equivalent volume of lower-cost gas, (the gas which is currently shut in), the consumer saving would be $3.5 billion. Similarly, if just half the current amount of gas imports, priced at $4.94 per mcf, were replaced by cheaper shut-in supplies, the savings would be $1.5 billion. In sum, replacing 1.2 trillion cubic feet of high-cost and imported gas with shut-in production would save $5 billion.

The outcome of the failure to use the 1 to 2 trillion cubic feet oversupply of gas to accomplish this is not simply that gas prices are far higher than necessary. Small producers, brought up to believe in the axiom that an entrepreneur who can provide a product at a lower price will gain market share, have been cruelly disappointed. Faced with severe cash flow problems and outstanding loans, they are suffering from financial strains which could climax in their extinction. The loss of small well owners could further enhance the position of the majors and producer/pipeline entities, lessening competition and creating the potential for even greater price hikes and market manipulation.

Market structure: This raises what is the fundamental problem: the lack of a true free market in the natural gas industry. The utility/consumer end of the gas pricing chain has very little bargaining power. Consumers have only one source of supply for gas and distribution companies face a similar situation, being connected to only one or two pipeline suppliers. The inability of either utilities or consumers to shop for the best deal is an underlying reason for the producer domination of the market and for the inability of end user signals to flow efficiently and expeditiously back to the production end of the system.

The theoretical conduit of market signals is the pipeline, which is supposed to consider both supply security and price concerns in driving the best bargain for its customers. However, as discussed earlier, the FERC's unwillingness to oversee PGA filings removes the major safeguard that pipelines are indeed acting in that role. The problem is compounded by the power of producers to force contracts which are beneficial to their interests but which run counter to those of the consumer. Reports abound of illegal "tie-in" arrangements, where producers require pipelines to purchase Section 107 gas along with regulated supplies or to agree to indefinite price escalators.[7]

Finally, it must be acknowledged that many pipelines are themselves producers or have producer affiliates. Since the law limits those pipelines from paying more for their own gas than they pay other producers, there is a built-in incentive to accept higher than necessary costs from other sources so that their own gas will garner higher prices. In both the Columbia and El Paso cases mentioned above, the pricing problem has been greatly compounded by the relation of the pipelines to their production interests. Both pipelines paid higher prices for their own gas than was warranted, since cheaper supplies were available. In the case of Columbia, its production affiliate actually served as its pipeline purchasing agent.

The various bills introduced to deal with this winter's pricing problems are in effect trying to balance the gas market by providing more bargaining power or protection to the utility/consumer segment. But it is important to remember that historic and institutional market structure imbalances will not be solved easily or quickly. There will have to be sufficient price protection safegaurds in place for some time before competition will be injected into the gas industry.

Immediate consumer impacts

The problems created by the shocking rise in natural gas prices are well-known and need not be addressed in detail here. You are all aware of the study by the National Council of Senior Citizens which concluded that one in four low-income elderly households spends more than 40% of its monthly income on winter fuel bills. In 12 states, the average energy bill during the coldest month exceeds the maximum SSI payment. In 9 other states, less than $25 per week is left from SSI payments after paying cold weather bills. This enormous burden, greatly exacerbated by rising gas prices, literally present a life-threatening situation for millions of our senior citizens.

You are also well aware of the effect rising gas prices are having on businesses, on farmers, and on unemployment. It is estimated that 50,000 jobs will be lost in Pennsylvania alone because of this year's high gas bills. Oklahoma farmers are facing increases of $3,000 per month as producers are cutting back production to qualify for stripper status, raising prices from $.50 per mcf to $3.50.[8] Rising gas prices are forcing shutdowns among U.S. ammonia manufacturers and creating havoc within the fertilizer industry. The problems are felt in virtually every state and in virtually every industry.

I would like today, however, to focus on a particular impact from rising gas bills: the problem of utility disconnections. Uncollectibles are becoming a major social problem which demands a prompt and effective response. As more and more people become unemployed or underemployed, the problem of affordable energy becames a life-and-death issue for millions of Americans who had previously been able to cope, even if barely, with their fuel bills.

The statistics are staggering. Boston Gas reports that it will have $10 million in uncollectibles by the end of this winter. Michigan Consolidated estimates $40 million and Baltimore Gas and Electric $6.1 million. Already, 6,000 families have been disconnected in Kansas City, 9,300 in Detroit, and 100 residences a day are shut off in Louisville.

The Citizen/Labor Energy Coalition studied the problem in its report, "Cold and Dark: Utility Disconnections in the United States." We found that roughly 240,000 gas heating households lost their heat during the winter months last year, up 50,000 from the year before. We estimate that 300,000 households will face part of this winter without heat because of their inability to pay for rising fuel bills.

There are three major reasons for the growth in the number of shut-offs. First, energy assistance money has declined relative to fuel increases for this winter. Although funding has remained constant for the last two years, it has not increased in relation to general inflation or energy inflation. Second, gas heating costs are up 25% in most regions of the country and in some colder areas, such as southern Illinois and Indiana, this winter's fuel bill will be 50% higher than last year's. Third, unemployment has continued to climb in the industrial Northeast, particularly in states such as Michigan, Ohio, Illinois, Indiana and Wisconsin which are suffering from the highest gas price increases.

While many states have instituted moratoria on shut-offs during the winter months or during particularly cold periods, many households were shut-off this year either during the spring or before the moratorium period began. In Massachusetts, for example, some utilities put on extra crews in April when restrictions were lifted, in order to disconnect thousands of customers.

I might say that many utilities have been struggling to deal with the problem and have instituted fuel aid donation check-offs as part of their monthly mailings. But, as Dennis Pines of the Ohio Public Utility Commission stated, "I've never heard of a fuel fund that generates enough dollars to take care of the problem." I also want to take this opportunity to bring to the Committee's attention a major problem surrounding some of those programs. While the Federal fuel assistance program contains an income disregard provision which protects recipients from having aid count as income for programs such as AFDC and SSI, some of the private fuel programs are not similarly protected. Thus, in some instances, recipients of utility fuel programs could see their limited social security checks reduced unless prompt action is taken to provide a similar income disregard provision for private efforts.

Legislative solutions

The enormous individual and macroeconomic consequences created by the leaps in natural gas prices provide compelling reasons for legislative remedies. We recommend that a comprehensive legislative approach be undertaken that addresses all of the major concerns enumerated in the first portion of this statement. That comprehensive approach would include the following:

--Elimination of onerous take-or-pay and indefinite escalator provisions. Take-or-pay provisions were originally included to protect producers against the risk of initial investment. But they have moved so far from that purpose that action must be taken to restrict their utilization. Take-or-pays now serve to prop up prices higher than the market can bear and guarantee profits not costs. Indefinite escalator provisions, particularly in conjunction with decontrol, subject utilities and consumer to uncertainy as to the exact costs they will be paying but provide certainty that those costs will be higher than warranted.

—Clarification of Section 601 authorities. While we believe that the

FERC currently has authority to prevent the pass-through of imprudent purchases, the Commission's failure to interpret its responsibilities in this light requires that Congress clarify its original intention and make the Commission responsible for ensuring that least-cost supplies are purchased. In order to provide a guarantee that the Commission acts in the future, contract filings should be made public and state public utility commissions and distribution companies should be provided with input into the oversight process.

—Prevent further backdoor decontrol actions by the FERC. The FERC should not be allowed to raise the price of gas under Section 107 without explicitly balancing the benefits of the expected new reserves against the additional costs to the economy, in light of less expensive alternative sources of gas available. Congress should further make it explicit that the FERC has no authority to raise old gas prices. Increases in the price of gas profitably produced before 1978 would give undeserved windfalls to producers.

—Limit Section 107 prices. It is clear that prices as high as $8 and $9 for high-cost gas are unsupportable in today's market. To prevent those prices, the FERC should either use its Section 601 authorities to block pass-throughs of imprudent high-cost gas purchases or should prevent those purchases from being rolled in with less expensive supplies. Requiring pipelines to sell their newly-acquired gas at prices reflecting the incremental cost would allow more rational purchase decisions and would place pipelines on an even footing with respect to their ability to bid for new supplies.

—Freeze prices, reduce the rate of escalation under the NGPA, and extend the scheduled deregulation date for new gas. The current pricing problems are so severe that these actions are required. Prices which are already above market-clearing levels in many areas of the country cannot be allowed to increase further.

All portions of this program must be implemented if consumers are to receive adequate price protection. It is particularly important that ceiling prices be maintained, although at levels lower than provided under the NGPA. We would argue strongly with the suggestions that removal of the ceilings would allow prices to drop. The logic behind that appears far removed from the recent record of wellhead pricing practices. Since producers are pricing at the maximum now, even in the face of load loss and market disruption, one might well wonder why they would be expected to drop their prices if controls were removed. Rather, one should questions whether contract prices wouldn't be even higher today absent controls. The argument that producers would lower prices to maintain sales is also highly debatable since it is the producers' own insistance on the highest possible price and onerous contract terms which have created today's market disarray. Removing the backstop of protection provided by controls either risks the very real possibility that producers will continue their past practices or will subject consumers to extraordinary misery during the length of time it takes to modify industry behavior and contracts.

Moreover, even many of those who argue for decontrol base their support on resolution of the "contract" problem through legislative action. The litigious nature of the gas industry ensures that any legislative or regulatory solution will undergo several rounds of court challenges. To decontrol before those challenges are resolved could result in the worst of all worlds: deregulation with the current contract provisions operating. The possibility is one of devastation and chaos.

Table A

Columbia Pipeline

Category costs	Mid-1981		Mid-1982		%Volume Change
	Volume (bcf)	Price (per mcf)	Volume (bcf)	Price (per mcf)	
Section 102	230	$3.02	195	$3.09	-15%
Section 107	4	$6.84	61	$7.63	+1425%

Total costs:	Mid-1981 price	Mid-1982 price
Section 102	$695 million	$603 million
Section 107	$27 million	$465 million
Total purchases	$1,367 million	$1,741 million

It can be seen from the above information that the primary reason for Columbia's higher prices is the purchase of higher volumes of high-priced 107 gas and a cutback in lower priced Section 102 gas.

El Paso

Category costs	Mid-1981		Mid-1982		
	Volume (bcf)	Price (per mcf)	Volume (bcf)	Price (per mcf)	% Volume Change
Old Gas	600	$1.17	534	$1.20	-11%
Section 107	34	$4.54	91	$6.90	+168%

Total Costs	Mid-1981 price	Mid-1982 price
Old Gas	$702 million	$642 million
Section 107	$154 million	$628 million
Total	$2,030 million	$2,887 million

The large increase in high cost gas supplies accounted for a substantial portion of the overall increased cost of purchase gas supplies. El Paso also increased its purchases of "new" gas from 378 bcf to 495 bcf. The price of this gas only increased from $3.05 per mcf to $3.20 per mcf.

Tennessee

Category costs	Mid-1981		Mid-1982		
	Volume (bcf)	Price (per mcf)	Volume (bcf)	Price (per mcf)	%Volume Change
Old Gas	786	$1.53	667	$1.54	-15%
Section 107	5	$4.91	24	$8.43	+380

Total costs	Mid-1981 price	Mid-1982 price
Old Gas	$1,203 million	$1,027 million
Section 107	$ 25 million	$ 202 million
Total	$1,939 million	$2,658 million

Tennessee increased its purchase of Section 107 gas by 380% at an increased cost of $175 million. It also increased its purchases of "new" gas by 100 bcf from 236 to 336, but the price increase only amounted to $.18 per mcf. Thus, while lower priced "old" gas purchases dropped sharply, such volumes were replaced with higher priced (in part) Section 107 gas.

Cities Service

Category costs	Mid-1981		Mid-1982		
	Volume (bcf)	Price (per mcf)	Volume (bcf)	Price (per mcf)	%Volume Change
Old Gas	208	$0.62	119	$0.68	-43%
Section 107	7	$3.34	15	$6.01	+114%

Total costs	Mid-1981 price	Mid-1982 price
Old Gas	$129 million	$81 million
Section 107	$ 23 million	$90 million
Total	$530 million	$522 million

Even though Cities Service overall gas purchase costs went down, the decrease would have been much greater were it not for the enormous decrease in volumes of old gas purchased.

Footnotes

1. DOE November Monthly Energy Review.
2. Analysis of Natural Gas Producer/Interstate Pipeline Contracts, July 1, 1981. Decision Analysis Corporation.
3. According to figures provided in "An Evaluation of Natural Gas Pricing Proposals," (a June 14, 1978 analysis memorandum prepared by DOE for the Senate Committee on Energy and Natural Resources), the average wellhead price for 1982 was expected to be $2.05 per mcf. The more recently price anticipated is $2.56 per mcf, a full 25% higher.
4. Energy User News (July 26, 1982) reported:

    > Natural gas is quickly losing its price advantage over No. 6 oil in most parts of the country, causing the loss of many industrial boiler users with dual fuel capacities, according to a cross section of gas utility officials and industry observers.

5. Washington Post, September 6, 1982.
6. Wall Street Journal, November 11, 1982.
7. Columbus Citizen Journal, September 30, 1981. According to the chairman of Columbia Gas System's affiliated distribution companies, Mr. Marvin White, "You can't go down there (to the Southwest) and buy regulated gas either. A producer may have several deep wells below 15,000 feet, unregulated gas, and if you want to buy his regulated gas, you take the unregulated gas or he won't sell to you."
8. Wall Street Journal, November 11, 1982.

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COLD AND DARK: UTILITY DISCONNECTIONS IN THE UNITED STATES

A report by the

CITIZEN/LABOR ENERGY COALITION

SUMMARY

This study assesses gas and combined gas and electric utility disconnections for the past winter and attempts to estimate the number of shut-offs that can be expected this coming winter, nationwide. The study, conducted during the fall of 1982, reviewed information on disconnections in 15 states in relation to a 1981 database covering 22 states. The findings are as follows:

-- 600,000 residential gas heat or combined gas and electric disconnections for non-payment of bills were documented in fifteen states for the period October 1981 through September 1982.

-- During that same period, over 1.2 million residences lost their gas or combined gas and electric service in the U.S.; assuming that each household could be disconnected twice, over 600,000 households were subject to a gas heat disconnection last year.[1]

-- About 240,000 gas heating households lost their heat during the winter months last year, up 50,000 households from the year before.

-- Disconnections for non-payment will be even more extensive this coming winter (1982-83): 300,000 households will face part of this winter without heat.

Utility disconnections are a growing problem across the country, with shut-offs in states representing all geographical regions. Some utilities, such as East Ohio Gas, have more than doubled their numbers of household disconnections this year compared to last. In Illinois alone, over 100,000 households were involuntarily shut-off last fiscal year. In Louisville, 100 residences are disconnected daily, with at least 20% of these families -- even those reconnected -- shut off for several days. In major cities like Baltimore and Minneapolis, thousands of households are going into this winter without any heat.

Data Characteristics

Sixty percent of all U.S. households heat with gas. The heat shut-off estimates do not consider electric space heat (8% of all heating households) lost due to disconnection, or those fuel oil and propane deliveries lost because of inability to pay. In addition, the heat shut-off numbers cannot account for the thousands of people who voluntarily go without heat to avoid disconnection and loss of gas for cooking and hot water.

Similar to figures for the previous year, the study finds a large jump in disconnections during the spring of 1982. In states with restrictions on winter disconnections there are large numbers of shut-offs in April and May. In Massachusetts, for example, some utilities put on extra crews in April when restrictions are lifted, in order to disconnect thousands of customers.

In states where there are few restrictions on winter shut-offs, the data suggests that many households are able to sacrifice enough to remain on the system for the duration of the winter, but lose their heat and electric service at winter's end. Across the country, there has been an enormous increase in 'seasonal' heating customers; many households simply forego all gas services, including hot water and cooking, from April through September, in order to afford winter services. There is no way to number those families who are unable to afford the reconnection fee come fall, and remain disconnected as winter arrives.

The Upcoming Winter

Approximately 300,000 households will face gas heat disconnections this winter (November 1 - March 30).

1. Energy assistance money has declined relative to fuel increases for this winter. Although funding has remained constant for the last two years, it has not increased in relation to general inflation and energy inflation.

2. Gas heating costs are up 20-30% in most regions of the country. In some colder regions, such as southern Illinois and Indiana, this winter's bill will be 45-50% higher than last year's.

3. Unemployment has continued to climb, particularly in the industrial Northeast -- the most densely populated area that is subject to severe winters. Many of the states with the highest unemployment figures are those same states with large gas price increases: Michigan, Indiana, Ohio, Illinois, Wisconsin.

Households will simply have less cash for greater expenses this winter. Moreover, state policies on winter utility disconnections do not show much improvement over last winter.

METHODOLOGY

This study analyzes a sample of service disconnections by gas utilities and combined gas and electric utilities during both the winter heating season of 1981-82, and the 1981-82 fiscal year. Twenty-five states' public utility commissions (PUCs) were contacted in the fall of 1982. They were asked to supply data for each gas, or combined gas and electric utility in their state. Residential disconnection figures for non-payment were the only figures requested, by month or season, for FY 1981-82.

Eight PUCs provided some data. Data for the remaining seven states included in the sample database were collected from utilities or consumer groups.

1. Sample Findings

Fifteen states are represented in the sample. For eight states, some data was collected for most major gas and combined gas and electric utilities. In all but several cases, small municipal utilities are not included. As with other data omissions, this biases the study toward underestimation of the problem.[2]

In order to obtain complete information about each of the sample states, the percentage of data available for each state was calculated. For the sample, 75% of potential data was collected. The 460,000 actual recorded disconnections for FY 1981-82, in the 15 states, were based on a sample including 75% of the population of these 15 states.

The data was checked for biases by weather, by fuel prices, and by months for which the data were available. The results have not been biased by any of these variables. Therefore, because it is a very large sample, it can be considered representative of the 15 states entirely. Extrapolating this 460,000 for this group of states implies 600,000 disconnections in our sample group last fiscal year.

2. Projecting to the Population

The sample represents 48% of all possible national (lower 48 states) data.[3] Such a large sample can be used as a basis for projections for the entire U.S. A conservative estimate drawn from the above numbers indicates 1.2 million disconnections nationwide last fiscal year. Correcting for duplication by halving this total, this translates into 600,000 households having faced at least one utility disconnection some time last fiscal year.

3. Biases Toward Underestimation

The sample probably underrepresents the actual number of disconnections for last fiscal year:

1. The 1.2 million disconnections is a projection from a sample accounting for 48% of all possible data. The sample may be biased toward states with tighter disconnection regulations or utilities with more generous credit programs.
2. The assumption that every household gets disconnected twice, halving the national FY projection to 600,000, over estimates the problem of double-counting.

4. Winter Shutoffs

A similar methodology was used in calculating winter shut-off estimates for the nation. Data was nearly complete for the 15 sample states during the winter heating season (November 1981-March 1982). The disconnection figure for the sample states, over 150,000, represented 48% of the nation as a whole. Projecting this to the entire nation for the winter season indicated over 320,000 disconnections.

This projection only includes 26 million of the 40 million gas heating households in this country, because of corrections for warmer climate and shut-off restrictions. However, even in the warmer states, whose numbers have not been considered in this study, much of the winter requires heat availability for the elderly and infirm.

Since the winter heating season contains only 5 months and statistics in many states are kept more closely at that time, double counting is not as much of a problem as it is year round. But, even assuming that about half of the households represented by the 320,000 were disconnected twice in the same winter, 240,000 families would have been affected.

5. Restrictions on Projections

In projecting the winter and fiscal year shut-off figures nationwide, two types of states were removed from the population so that the problem would not be overestimated among gas heating households. First, states were removed where regulations make disconnections difficult, and/or there are a small number of gas heaters. Second, warm states were eliminated.

Thus, the total gas heat population is reduced from 40 million to 26 million residences.[4] The gas heating sample, of 12.45 million houses, is nearly half of the total target population. A straightforward projection of the more than 150,000 documented gas heat or combined gas and electric utility disconnections out of 12.45 million suggests at least 320,000 gas heat shut-offs during last winter.

Significantly, once the warmest states are removed from the population, winter shut-offs do not vary by temperature. This is due to several factors:

1. While gas consumption is higher in states like Illinois and Maryland than in states like North Carolina, all states have gas heating households that pay $100 or more for at least one gas-heating month. That is, the cost of gas is substantial in all but the warmest states, such as Florida.

2. Southern states have less restricted winter disconnection policies.

6. Further Sample Characteristics

Like the projection for the fiscal year, many people who went without heat for the winter months last year were not accounted for in our sample.

a. Electric space heating customers were not included in the analysis since electric heat concentrations were not captured in our sample data.

b. Many gas furnaces have electric starters. Disconnections by the electric utility means loss of heat in households with this characteristic. Very few of these were counted.

c. The warm states that have been excluded often have temperature dips below freezing. These states typically have no substantial restrictions on winter shut-offs.

d. Many small municipal utilities have been excluded, as have rural areas where families derive their heat from propane or fuel oil delivery.

e. Commercial disconnection was excluded. Many state PUCs report multi-unit housing as commercial rather than residential property. The problem of multi-unit owner non-payment is widespread, particularly in northern urban areas, and often results in building heat disconnections and tenant abandonment.

IMPLICATIONS

The 1.2 million year round and 240,000 winter residential gas heat disconnections are a small part of an accelerating problem. Because the issue of utility disconnections is both politically and morally charged, and these statistics are subject to inflation, every effort has been made to provide conservative projections.

Two implications require no numerical extrapolation.

Clearly, the problem of disconnections for non-payment is extensive in states for which data is available. States that do not require reporting should immediately initiate proceedings to do so. Lack of information cripples effective lobbying for fuel assistance and rate reform. Inadequate attention to these problems is not in the interest of the consumer or the utility.

Even more important, accelerated decontrol of natural gas prices has already and will continue to exacerbate the spiraling trend of increasing disconnections. If natural gas bills double again over the next two years, people who were shut-off in FY 1982-83 will have increased difficulty in obtaining and keeping utility service. Many people who have barely escaped shut-offs in the past, and even those who have traditionally been able to pay their bills, will be denied a neccesity in the face of the harshest season.

NOTES

1. Since many households can be disconnected for non-payment more than once in a twleve month period, the 1. 2 million gas heating shut-offs does not represent numbers of households. No data exists on such multiple disconnections, but a conservative estimate is that 600,000 households are represented by the 1.2 million. Halving the total shut-offs allows for the assumption that every household was disconnected twice. Alternatively, the halving permits the assumption that 2/3 of the disconnected households were disconnected four times during FY 1981-1982.

2. The fifteen states are Illinois, Iowa, Kentucky, Maryland, Minnesota, Missouri, North Carolina, North Dakota, Ohio, Pennsylvania, Rhode Island, Utah, Virginia, Wisconsin and the District of Columbia.

3. Ideally, one would want 12 months of disconnection data for each utility by each state. To determine the percentage of data within the sample, relative to the ideal, three variables were introduced: number of households within the state, percentage of households served by major utilities reporting data within the state, and oercent of months for each state's utilities for which data were available.

4. States excluded from the population for extrapolation purposes.
   a. States with policies making winter disconnections difficult and/or states with a small number of gas heaters are Connecticut, Delaware, Idaho, Maine, Massachusetts, Montana, New Hampshire, Oregon, South Dakota, Vermont and Washington.
   b. Warm states, below 2900 winter heating season degree days (30-year normals): totally excluded are Alabama, Arizona, Florida, Georgia, Louisiana, Mississippi and South Carolina.
   c. Warm states having 80% of their gas heating households excluded from the population are California and Texas (minus Dallas-Ft. Worth).
   d. States, other than those sampled included in the population are Arkansas, Colorado, Kansas, Nebraska, New Mexico, Tennessee,

New Jersey, New York and West Virginia.

e. Twenty percent of California's gas heating households and 20% of Texas' (less Dallas-Ft. Worth) were included.

f. Also included are 2 million household among sample states for which data were not available.

Gas heating households excluded from the population count:
a. (1.4 million) + b. (3.5 million) + c. (9.6 million) = 14.5 million

Gas heating households included in population count:
sample states (12.45 million) + d. (10.65 million) + e. (2.4 million) + f. (1.5 million) = 26 million

citizen/labor energy coalition

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The Purchased Gas Adjustment: A Closer Look At Why Natural Gas Prices Are Increasing

A REPORT
by
The Citizen/Labor Energy Coalition

September 19, 1982

Introduction

While there is growing concern in many parts of the country that natural gas prices are already too high, purchased gas adjustment filings before the Federal Energy Regulatory Commission for six month periods beginning on July 1, 1982 indicate that gas prices will continue to escalate during the fall and winter months. Purchased Gas Adjustment (PGA) filings are made with the FERC every six months (a few file once a year) by interstate pipelines. The FERC currently allows the pipelines to pass through rate increases to its customers automatically one month after the adjustment is filed. Most often the PGA is the increase in the rates pipelines are allowed to charge their customers for gas purchases they themselves expect to make in the forthcoming six month period.

The FERC generally allows the higher rate to go into effect without challenge. In fact, for most filings few are contested and even fewer are significantly altered.

Through the process of the PGA filing pipeline companies are able to pass on higher gas purchase costs to their customers. Their customers (for the most part local gas utility companies) in turn pass on the increased prices to their customers -- residential, commercial, industrial and other users. Thus, it is a fairly simple process to calculate the cost impact of the PGA rate changes on gas users and on states as a whole.

Findings

- During the fall and winter months, the PGA rate increases examined in this study (those going into effect July 1st, August 1st, September 1st and October 1st) will cost gas users over $2 billion.

- The states of California, Ohio, Pennsylvania and New York will be paying the largest amounts. They will pay $264.4 millions, $246.3 million, $153.4 million and $141.3 million, respectively in higher gas bills due to the increases contained in the PGA filings of the pipelines serving those states. (See Table 2).
- The New England, Mid-Atlantic, East North Central and South Atlantic regions will face increased gas costs of $52.3million, $367.7million, $446.2 million and $176.5million, respectively.
- The PGA's examined in this report will result in an average household consumer increase averaging $50 for the relevant six month period.

Methodology

We have calculated by state the initial direct cost impact on gas users of the PGA's filed by major interstate pipelines from July 1st to October 1st of this year. To arrive at the consumer impact estimates (See Table 3), we first determined the total revenue increase for each pipeline (for the relevant six month period). This cost was then allocated among the states served by the pipeline and among sectors within each state, all of which wereweighted by annual consumption patterns.

Table 1 presents the rate increases for the major pipelines, their effective dates, the total amount of revenue due to the increase in rates, and the percentage increase over the previous rate. All double-counting resulting from sales between pipelines has been eliminated.

The PGA filing (or net rate adjustment) is composed primarily of three main components: 1) the current purchased gas cost adjustment, 2) a surcharge to recover gas purchase costs that were unanticipated (and therefore unrecovered) during the preceding six month period, and 3) a special surcharge for rate changes due to FERC action or other such changes.

Table 3 presents the cost impact on four regions and breaks down the impact by consuming sector. In this table we assume the cost increases are spread evenly throughout the state. The average residential figure is the actual number of dollars an average household in the state will pay over the six month period for its share of the PGA increase.

It should be noted that the figures in this report significantly understate the total costs of purchased gas adjustments filed with the FERC, because only major interstate pipelines are included and because a few of the major pipeline companies, such as Michigan Wisconsin, Northern Natural and Southern Natural have not filed their PGA's during the four month period examined by this report.

Conclusions

Consumers are being charged higher gas prices not only because certain categories of natural gas under the Natural Gas Policy Act are allowed to increase in price, but because pipelines have little incentive to bargain with producers for lower gas prices. As the gas surplus increases daily and as demand for gas continues to decline, pipelines are continuing to pay the highest possible price for most categories of gas. Thus, for the most part, gas prices are continuing to increase because interstate pipelines have failed to respond to the signals of the marketplace.

In many markets across the country the delivered price of gas already exceeds the OPEC price of oil. Despite this fact, gas prices will continue to rise this fall and winter. A large part of the increase in price will come from the increases in rates pipelines have been allowed to charge their customers under the Purchased Gas Adjustment (PGA) provisions. In some cases, pipelines are passing through the cost of "high cost" gas purchases, while at the same time these pipelines are refusing to purchase gas that is available at lower prices.

Based on the current and previous PGA filings, we anticipate that increases of the magnitudes analyzed in this report will continue, at least until either Congress or the FERC deals directly with the problem of pipeline/producer contracts and the reasonableness of allowing pipelines to pass through gas costs which exceed the "market clearing level" of OPEC oil prices. Thus, consumers across the country, from Los Angeles to New York can expect to see increases ranging from 20 percent to 30 percent in their annual gas bills.

Table 1

Estimated PGA Rate Increases for Fall and Winter

Pipeline Company and Effective Date	Net Rate Adjmnt. (¢ per Mcf)	% Change	Revenue Increase (millions $)
Effective July 1			
East Tennessee	42.0	14%	$ 14.3
Tennessee Gas	40.0	14%	$183.4
Midwestern	30.0	10%	$ 25.5
United	67.0	20%	$228.8
Effective Aug. 1			
Texas Eastern	43.0	13%	$128.0
Texas Gas Trans.	57.0	15%	$114.5
Effective Sept. 1			
Columbia	72.0	20%	$413.3
Consolidated	55.5	15%	$181.0
Nat. Gas Pipeline	5.5	2%	$ 45.9
Panhandle Eastern	69.0	25%	$235.8
Transco	53.0	20%	$227.9
Trunkline	(45.0)	(13%)	$(71.3)
Algonquin	43.0	12%	$ 33.1
Effective Oct. 1			
El Paso	55.0	15%	$318.6
Florida Gas	23.0	7%	$ 10.4
Arkla	18.0	8%	$ 30.0
Total to date			2,057.4 million

Source: Pipeline PGA filings with the FERC.

Table 2

Impact on States of Fall and Winter Pipeline PGA Filings

State	Impact (in millions of $)
California	$264.4
Ohio	$246.3
Pennsylvania	$153.4
New York	$141.3
Illinois	$ 92.6
New Jersey	$ 73.1
Michigan	$ 63.6
Maryland	$ 58.0
Virginia	$ 51.9
Indiana	$ 43.2
West Virginia	$ 37.3
North Carolina	$ 36.5
Kentucky	$ 32.5
Massachusetts	$ 31.8
Tennessee	$ 29.7
Florida	$ 17.3
Arkansas	$ 16.5
Connecticut	$ 14.4
Missouri	$ 13.0
D.C.	$ 12.0
New Mexico	$ 9.6
Rhode Island	$ 5.2
Iowa	$ 3.7
Kansas	$ 2.9
New Hampshire	$ 0.9
Minnesota	$ 0.5
Nebraska	$ 0.5
Wisconsin	$ 0.5

Table 3

Impact of Fall and Winter Pipeline PGA Rate Increases On End Users By State and Region

Region/State	Total (millions $)	Residential (millions $)	Commercial (millions $)	Industrial (millions $)	Ave. Resid. (in dollars)
New England	$ 52.3	$26.2	$ 13.9	$10.1	
Conn.	$ 14.4	$ 6.5	$ 4.0	$ 4.0	$44.00
Mass.	$ 31.8	$16.6	$ 8.2	$ 5.0	$43.00
N.H.	$ 0.9	$ .4	$ .4	$ .1	$44.00
R.I.	$ 5.2	$ 2.7	$ 1.3	$ 1.0	$44.00
Mid Atlantic	$367.7	$153.0	$ 63.3	$104.5	
N.J.	$ 73.0	$ 29.4	$ 13.2	$ 13.4	$43.00
N.Y.	$141.3	$ 64.4	$ 26.3	$ 21.9	$50.00
PA.	$153.4	$ 59.2	$ 23.8	$ 69.2	$54.00
South Atlantic*	$176.5	$64.5	$ 35.4	$ 61.6	
D.C.	$ 12.0	$ 5.5	$ 5.5	$ 0.2	$64.00
MD.	$ 58.0	$ 25.3	$ 10.6	$ 20.1	$64.00
VA	$ 51.9	$ 18.9	$ 11.3	$ 19.2	$47.00
West VA.	$ 37.3	$ 14.0	$ 6.3	$17.0	$60.00
Florida	$ 17.3	$ 0.8	$ 1.5	$ 5.2	$12.00
East North Central*	$446.2	$193.0	$84.0	$163.1	
Illinois	$ 92.6	$ 40.6	$19.3	$ 30.9	$11.00
Indiana	$ 43.2	$ 15.0	$ 6.1	$23.1	$ 8.00
Michigan	$ 63.6	$ 29.0	$14.1	$ 18.3	$23.00
Ohio	$246.3	$108.2	$44.4	$90.8	$61.00
Wisconsin	$ .5	$ .2	$ .1	$ .2	$-----

Note: Impact amounts weighted by state consumption data from EIA.

* Does not include increases for Southern Natural (S. Atlantic) and Michigan-Wisconsin and Northern Natural (East North Central).

Senator WARNER. Thank you.
Mr. Schachman.

STATEMENT OF STEPHEN SCHACHMAN, PRESIDENT, PHILADELPHIA GAS WORKS, AND CHAIRMAN, ASSOCIATED GAS DISTRIBUTORS

Mr. SCHACHMAN. I am Stephen Schachman, chairman of AGD. We certainly concur with the sense that Congress must act and we concur with the sense that we believe that now is not the time to act. It requires more study and we hope there will be action early in 1983, because we believe the only thing that can be done now to give immediate relief at the burner tip is to increase low-income energy assistance.

We hope that this committee will support that fully in the following week.

We say that there are a number of things that have to be addressed, the escalators, take or pay, market outs and as we just discussed a prudence test and a review of PGA's.

My final comment would be that we have heard a lot of talk this morning that NGPA is causing the problems. What seems to be overlooked is that NGPA is supposed to set ceiling prices. There is no restriction that the producers could not have with pipelines renegotiations of the prices established. But there is no incentive and the take or pays to have the right to continue.

Therefore, until that incentive is removed we will not see a significant downward trend in gas prices.

[The prepared statement of Mr. Schachman follows:]

Natural Gas Policy

Prepared Statement of

STEPHEN SCHACHMAN

Chairman, Associated Gas Distributors
President, Philadelphia Gas Works

INTRODUCTION

Good morning Mr. Chairman and Members of the Committee. I am Stephen Schachman, President of the Philadelphia Gas Works and Chairman of the Associated Gas Distributors upon whose behalf I appear here today. The Associated Gas Distributors (AGD) is an association of some 60 natural gas distribution companies which provide gas utility service along the Eastern seaboard.[1/] The AGD member companies serve more than 11 million gas customers and account for approximately 25 percent of the total interstate sales of natural gas. No AGD member companies are owned by or affiliated with any major gas producer or major gas pipeline company. For many years, AGD has represented the interest of East Coast gas distributors before the Federal Energy Regulatory Commission and Congress on natural gas policy matters which affect the competitive pricing of natural gas and the assurance of long-term supply security. AGD appreciates this opportunity to appear

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[1/] A list of the AGD member companies is appended hereto.

before the Committee on Energy and Natural Resources to evaluate current natural gas policy, to provide you with our perspective on the several years of experience under the Natural Gas Policy Act and to raise some serious problems which we foresee as the gas industry moves toward wellhead price decontrol.

In our view, there are four areas of natural gas policy which demand congressional attention prior to our industry's transition to a substantially deregulated wellhead pricing environment in 1985. The four areas of concern are:

1. the need to bring retail gas market signals more quickly and more accurately to the wellhead marketplace,
2. the need to assure that gas distributors can be informed as to the supply acquisition prices and practices of their interstate pipeline suppliers and can act to protect their interests,
3. the need to remove the economic windfalls to natural gas producers under the NGPA, and
4. the need to enhance interstate gas supply security through regulation of pipeline transportation service.

The remainder of my statement will elaborate on these areas of concern and then address several other issues posed in the Committee hearing notice.

I. The Need To Bring Retail Gas Market Signals More Quickly and More Accurately to the Wellhead Marketplace

Natural gas producers, interstate pipelines, Congress and the Federal Energy Regulatory Commission (FERC) through the Natural Gas Policy Act have created numerous institutional and contractual arrangements which together operate to insulate gas producers and pipelines against the free market environment which is encountered in the retail energy marketplace where gas distributors operate. There are significant institutional barriers to the transmission of consumer signals received in the marketplace by gas distributors in response to higher and higher gas prices received by the gas producer at the wellhead. These barriers to the efficient operation of free market forces must be removed.

A "free market" and the resultant competitive pricing of commodities presuppose that both consumer prices and producer rewards will be established through the interaction of supply and demand signals moving back and forth between producers and consumers. But, the gas industry today is not a back and forth economic process; it is more like a one-way street, where only the gas retailer really feels the impact of consumers' market signals. The barriers to transmitting market signals "upstream" to the interstate pipelines and producers are formidable.

Many gas consumers, particularly industrial users, do "signal" the retail distributors by exercising their fuel-switching options whenever it is economic to do so. Gas distributors hear and heed these consumer messages. Indeed, distributors must respond properly to such market conditions, for they have no guaranteed markets, no guaranteed right to passthrough purchased gas costs, and no automatic, one-way price escalators their customers must pay. On the other hand, the interstate pipelines and the gas producers, have accomplished all of the foregoing through contractual relationships and FERC regulations.

In short, the risks inherent in a free market have either been removed or grossly limited with respect to pipelines and producers and now rest almost exclusively with gas distributors. Congressional attention to these barriers to market signals as detailed below is essential prior to 1985 if the gas industry is to have a reasonable chance of achieving market-determined prices for new gas in 1985 under the Natural Gas Policy Act.

- First, as public utilities regulated by state public utility commissions across the nation, natural gas distribution companies have no guaranteed right to passthrough their purchased gas cost to their customers. State commissions exercise a review and auditing function over purchased gas costs incurred by distributors. The distributors' "right" to pass such costs along to their customers is dependent upon this review which often involves hearings to assess the reasonableness, prudence and public interest considerations of allowing distributors to recover purchased gas costs from their customers. In stark contrast, the interstate pipelines do enjoy a guaranteed purchased gas costs passthrough pursuant to Section 601(c)(2) of the Natural Gas Policy Act (as now interpreted by FERC), unless it can be shown that the pipelines engaged in "fraud, abuse or similar grounds" in buying gas. This federal/State standard of review dichotomy creates several unacceptable consequences for gas distributors.

The fact that retail gas distributors at the State level are held to a higher standard of accountability in justifying their purchased gas costs than is applied to their "regulated" pipeline suppliers is a major element in the "one-way street" now prevailing in the gas industry. "Guaranteed passthrough" is another name for guaranteed markets or sales. Thus, the risk and exposure to free market forces is held predominately, if not exclusively, by gas distributors.

As to cost discipline, the pipelines' guaranteed passthrough right is wholly counterproductive. It minimizes the incentive for the pipelines to provide gas at lower prices, and it relieves the pressure otherwise present for pipelines to bargain vigorously with their producer/suppliers.

The implications of the pipelines' guaranteed passthrough in light of the dichotomy thereby created in federal/State purchased gas costs review are untenable for gas distributors. State commissions have historically permitted distributors to collect most of their pipeline purchased gas costs. This has been true largely because those costs have been subject to review in the first instance by FERC. When the FERC role is, however, relegated to assuring pipelines a guaranteed passthrough, then gas distributors are exposed to a State level audit of purchased gas costs imposed by pipelines over which the distributors have little knowledge and no control. The pipeline's guaranteed passthrough insulates it from any duty to demonstrate the prudence of its purchases, and the distributor, who is least able to defend such purchases, is left to do so anyway because the distributor is simply the only segment of the industry remaining with a regulatory accountability review. This is an untenable position now, and one which will worsen as we enter 1985 decontrol and purchased gas costs rise dramatically.

The fact is that there are no "guarantees" in a free market. Because gas distributors have no market guarantees, it is both unfair and economic nonsense for the interstate pipelines to retain their guarantee. We urge you to act to put pipelines on the same market risk footing vis-a-vis purchased gas costs as distributors. To accomplish this, NPGA section 601(c)(2) should be amended to remove the pipelines' guaranteed passthrough rights and to restore the pipelines' burden to comply with the "prudence" standard for the review of purchased gas costs.

Second, a permanent mechanism is necessary in the regulation of interstate pipelines to assure their attention and responsiveness to retail market conditions. In this regard, we recommend that Congress require FERC to establish an incentive rate of return system for interstate pipelines whereby a pipeline's return on equity in any rate increase proceeding would be related to the usual factors and to the pipeline's performance in three key areas: its volume of gas delivered as compared to the requirements of its customers, its average cost of gas and its gas reserves position. Further, pipeline customers should be entitled by statute to initiate FERC review of a pipeline's return allowance (when no rate case is pending) based upon evidence of the pipeline's recent performance in these same three areas -- volumes delivered vis-a-vis customers' requirements, average gas cost and reserves position. With such mechanisms in place, the pipelines would experience returns on equity commensurate with their performance and could be held tangibly accountable for any gas acquisition practices which adversely affected their customers' ability to compete in the retail energy marketplace.

Third, a recurring problem in pipeline regulation is the frequency and size of pipeline rate increase filings. A rate increase disincentive system is necessary. We suggest that FERC be required by statute to set the interest rate at which refunds would be paid by pipelines on over-collections at a level high enough to discourage repetitive or excessive rate increase filings.

Fourth, it is readily apparent from information now surfacing regarding provisions in pipeline gas purchase contracts that indefinite price escalation clauses, including "most-favored-nation" clauses, will cause prices for deregulated gas in 1985 to rise dramatically above the level otherwise derived through free market forces. The indefinite price escalation clauses typically peg new gas wellhead prices in 1985 to the mmbtu equivalent of no. 2 fuel oil or higher. Wellhead prices at this level produce burner-tip retail prices which are simply unacceptable to large portions of the retail market. If such pricing provisions were limited to some modest amount of gas, the distributors' retail markets could probably survive. However, most wellhead gas purchase contracts also contain "most-favored-nation" clauses. These provisions operate to spread the indefinite price escalation clause price levels throughout the universe of new gas contracts. Thus, at the time of decontrol of new gas in 1985, some 50 to 75 percent of all gas sold in the interstate market is likely to jump to price levels vastly in excess of anyone's notion of market-determined prices.

The consequences of the foregoing scenario for gas distribution companies and their customers are disastrous. While we continue to urge FERC to exercise its contract-regulating authority to nullify these types of pricing provisions, it is apparent that FERC will not act. Thus, the need for remedial legislation represents a crucial problem for gas distributors.

I might add here that over the long-term, we expect natural gas prices at the wellhead to moderate in response to customer resistance to higher prices established by indefinite price escalation clauses. However, the long-term in an industry as heavily regulated at the pipeline and distribution levels as the natural gas industry, means anywhere from two to five years. This is an unacceptably long period for distributors to bear the brunt of noncompetitive prices for their only product. Accordingly, we see no alternative to congressional action to declare indefinite pricing provisions (including NGPA escalators) in existing and future wellhead sales contracts unenforceable.

Fifth, as I have said previously, in a free market there is no such thing as a "guarantee." Yet another commonly found provision in gas purchase contracts which offends this concept is the requirement that interstate pipelines take-or-pay for large quantities of deliverable natural gas regardless of market demand. The effect of take-or-pay for provisions is to guarantee the producer-seller's market. We are seeing today in gas purchase contracts provisions which require interstate pipelines to take-or-pay for 90 percent or greater of the daily or monthly deliverability of a particular well or field. If the pipeline is unable to take the gas as required under the contract, it must pay for that gas with no assurance that this prepaid gas will actually be delivered later when the pipeline is able to accept it. Further, since the high take-or-pay for provisions are most frequently found in new, high priced gas contracts, the interstate pipelines are often precluded from exercising "economic dispatch" -- that is, they are contractually unable without penalty to take their supplies from their lowest cost sources first. Instead, they must often take the higher cost gas and hold back or "shut-in" the low cost supplies at a time when consumers are least able to absorb the burden of higher cost gas.

For these reasons it is our view that the take-or-pay contracting practice represents yet another institutional barrier which must be removed or modified before any of the intended benefits of a free market will exist in the natural gas industry. Our judgment is that the take-or-pay percentage factor applicable to presently committed gas reserves should be limited by statute to 50 percent.

Sixth, to the extent future pricing arrangements in interstate pipelines' contracts have come to light in various ways, it is clear that many of these agreements will bring about 1985 prices which are not market-determined and, in fact, are completely incompatible with a deregulated gas market. Accordingly, corrective action with respect to these market-distorting contract provisions is essential if the NGPA is to produce prices approximating market-determined prices in 1985. We believe that FERC's authority to regulate contracts and practices under Section 5 of the Natural Gas Act is a valid legal basis upon which action could be taken as appropriate to facilitate the free flow of market signals. FERC, however, is apparently unclear about the extent of its legal authority to address this problem and is unlikely to act. It is, therefore, necessary for Congress to require "market kick-out" provisions in existing and future pipeline/producer contracts. "Market kick-out" is a term used to describe language in a gas purchase contract which gives an option to the pipeline buyer to terminate the contract whenever it appears that the pipelines' markets will not support the price required under the contract. This is one of the few provisions which would permit pipelines to adjust their average gas cost downward to meet market conditions, such as decreases in alternate fuel prices.

Seventh, and finally, another element in the system which creates the one-way street I have mentioned is the pipeline minimum bill provision. To the extent these provisions are necessary to support the financial feasibility of a pipeline system, they are justifiable. But to the extent these tariff arrangements merely guarantee pipeline revenues from their markets notwithstanding the retail gas distributors' ability to compete with other fuels, they are as offensive as the take-or-pay for provisions discussed earlier.

Here again, we believe that FERC's legal authority is sufficient to regulate pipeline minimum bill provisions which serve mainly to protect markets and are not crucial to the pipelines' financial integrity. However, in view of FERC's reluctance to act, Congress should require FERC to investigate pipeline minimum bills and to revise pipeline tariffs as necessary.

If the above seven items are addressed by Congress as suggested, then the producer and pipeline invincibility to free market forces will be removed, and they will operate on an equal footing with natural gas distributors vis-a-vis their marketplace. These seven items form the necessary prerequisite for achieving market-determined prices for new gas in 1985.

II. The Need To Assure That Gas Distributors Can Be Informed As To The Supply Acquisition Prices And Practices Of Their Interstate Pipeline Suppliers And Can Act To Protect Their Interests

To provide any reasonable basis for auditing the rate increase filings and the gas acquisition prices and practices of interstate pipelines it is absolutely essential that all first sale gas purchase contracts be filed with the Federal Energy Regulatory Commission and be made publicly available. This is a routine practice at most state level utility commissions and is entirely appropriate and necessary at the federal level. The FERC has authority pursuant to Section 4(c) of the Natural Gas Act and Section 315(c) of the Natural Gas Policy Act to require such filings today. It has, however, shown no inclination to exercise this authority despite repeated requests to do so. In the absence of access to the terms of pipeline gas supply agreements, there is no independent basis to confirm that the amounts for which the pipeline asserts its "guaranteed passthrough" right are in fact amounts the pipeline is obligated to pay by its contracts. Similarly, without knowledge of future pricing obligations incurred by a pipeline as to its new gas reserves, gas distributor-customers are unable to know or even to estimate in advance whether a given pipeline's gas will be available at marketable prices. No business can endure indefinitely without being able to forecast the cost of acquiring the only commodity it sells. Accordingly, we urge Congress to require the filing of all gas purchase contracts with FERC.

A further flaw we see in the present gas industry institutional arrangements is the doubtful legal capacity or "standing" of gas distributors to assert any rights or enforce any terms under a pipeline's contract with its producer-supplier. There is a question whether gas distributors may qualify as "third party beneficiaries" of agreements made by their pipeline suppliers for long-term gas reserves, even though such reserves are destined for resale to distributors and form the basis for the distributors' economic survival. In this situation, gas distributors would have no choice but to rely on their pipeline suppliers to protect their interests in their supply agreements. As we have seen in the case of the area rate clause dispute and in connection with the Order No. 93 Btu adjustment issue, the pipelines' incentive to "represent" their customers' interests in supply contracts is not an altogether reliable form of protection.

At a time when FERC's regulatory authority over natural gas transactions has been cut back significantly, and will be curtailed further via NGPA's decontrol provisions, there is good reason to doubt whether FERC will provide a forum where distributors' interests can consistently be represented or heard. Accordingly, Congress should specifically provide by statute that gas distributors have standing at FERC to seek and obtain interpretations on the terms of pipeline gas supply agreements with producers.

III. The Need To Remove The Economic Windfalls To Natural Gas Producers Under The NGPA

In a number of instances of FERC interpretation of the Natural Gas Policy Act, the Commission has ignored or departed from congressional intent and adopted policies or rules which have the effect of increasing gas prices at the wellhead without creating commensurate supply benefits. In considering Natural Gas Policy Act issues, we think Congress ought properly to address these matters and reinstate the policies intended by NGPA.

First, while it is clear that the NGPA was intended to provide maximum ceiling wellhead prices, and not override any existing contractual provisions which establish lower prices, the FERC has in two instances permitted so-called "area rate clauses" to escalate contract prices automatically to the NGPA maximum lawful prices. In FERC's Order No. 23 series of decisions dealing with contract price escalations to NGPA maximum lawful prices, the Commission has permitted producers to collect prices at the NGPA ceiling price levels based upon the contractual authority found in "area rate clauses" in gas purchase contracts. It is readily apparent that many, if not most, of the area rate clauses, when drafted, did not contemplate legislatively enacted prices. Yet, the Commission has interpreted NGPA not only to permit the clauses to escalate contracts to the NGPA prices, but also to preclude effectively any intervening parties from successfully objecting to the absence of contract authority to permit such prices in spite of the fact that hundreds of millions of dollars are at stake.

Nothwithstanding many years of industry practice recognized by producers and pipelines alike, in another recent order the FERC has allowed producers to collect NGPA prices based on a "dry" measurement of Btu content of the gas steam as opposed to the traditional "wet" measurement technique. This decision has the effect of raising across-the-board all natural gas prices nationwide by approximately two percent. As in the Order 23 series noted above, the Commission has so far permitted this wet/dry increase in gas pricing to be accomplished through an interpretation of area rate clauses in pipeline-producer gas purchase contracts.

Each of these examples illustrates the "one-way" pricing street and points to the need to clarify or reinforce the principle that NGPA ceiling prices are only available to producer-sellers who are contractually authorized to collect such rates. Our suggestion in this regard is that Congress act, in any review of the NGPA, to clarify further and make explicit the Section 101(b)(9) NGPA contract authority requirement for price escalations of this nature.

A second area in which the Commission may ultimately provide producers higher wellhead prices than anticipated by Congress deals with the quality of gas produced at the wellhead. In a number of dockets, FERC is considering providing allowances in addition to the maximum lawful price to producers for such work as compression, gathering, processing and other activities required to bring gas up to the pipeline quality standards. AGD's view on this subject is that producers have an obligation to provide "pipeline quality gas" and, in return for providing such gas, are entitled to collect the maximum lawful price. Where the producer provides something less than "pipeline quality gas," then it should bear whatever costs are necessary to bring that gas up to pipeline quality or should deliver its below-standard gas at a discounted price. We believe this principle was intended by NGPA and that it makes sense. To remove any uncertainty, however, a remedial amendment would be a significant improvement to the status quo.

Another item in this category concerns FERC Orders No. 58 and 98 which address the pricing of "old" pipeline-owned production. In these orders the FERC determined that a limited amount of pipeline-owned production should be priced on a "cost of service" basis as opposed to receiving the maximum lawful prices under the Natural Gas Policy Act. This decision has recently been reversed by the United States Court of Appeals for the Fifth Circuit and is now pending before the Supreme Court. This is a situation where the pipelines initially sought cost of service pricing of their gas primarily because those prices were higher than the applicable area rate prices. That is, an incentive price was paid by the pipelines' customers many years ago for this gas production. Now, when it turns out that even higher prices are available under the Natural Gas Policy Act, the pipelines have moved to obtain those prices even though their cost of production has not increased commensurate with the prices available under the Fifth Circuit decision. Moreover, no additional supply commitments will be forthcoming under the NGPA incentive price. Our suggestion on this point is that Congress review the entire subject of pipeline-owned production and codify FERC's Orders No. 58 and 98 so as to retain the benefits already paid for by the pipelines' customers many years ago.

IV. The Need To Enhance Interstate Gas Supply Security Through Regulation Of Pipeline Transportation Service

While gas distributors are concerned about the higher and higher prices brought about under NGPA, we are equally concerned with long-term supplies available to the interstate markets. For many years, the principle has been established that offshore federal domain gas is "interstate" and should be dedicated to interstate pipeline system supplies. The development of the offshore has been, for the most part, due to the interstate systems, and the long-term supply benefits are necessary to maintain a viable interstate gas system. In this regard FERC issued in 1979 its Opinions No. 10 and 10-A which agree with this principle. However, those opinions are now under active reconsideration by the Commission and are the subject of pending legislation in Congress introduced by Senator Johnston and Congressman Gramm. The pending legislation would reverse the 10-10-A principle, and the Commission may well do so itself. Accordingly, AGD strongly supports the statutory codification of the principle that all offshore federal domain gas is and remains dedicated to the interstate pipeline system.

In addition to being purchasers and resellers of natural gas, interstate pipeline companies also provide transportation services. Facilitating pipeline transportation of distribution companies' gas up to contract demand levels will enhance market discipline in the future. .The easier it is for distributors to obtain pipeline transportation of gas purchased from sources other than their pipeline suppliers, the greater will be the distributors' ability to "shop" for the cheapest supplies, send price signals to pipeline suppliers and create price competition at the wholesale level. Conversely, the more difficult it is for distributors to arrange for such transportation, the more they will be tied to their pipeline suppliers and their ability to shop and send market signals will be reduced.

One primary purpose of Section 311(a) of the NGPA was to facilitate pipeline transportation of distributors' gas by eliminating the certificate requirement for certain transportation arrangements. The only criterion specified in the statute is that the rates and charges for such transportation must be just and reasonable. However, the Commission's regulations under Section 311 have frustrated the intent of Congress. The experience of East Coast distributors has been that obtaining Section 311 transportation of their gas supplies by interstate pipelines has been difficult at best. In many cases, pipelines have simply refused. The reason for this is quite simple; the Commission's regulations under Section 311 provide pipelines with no financial incentive to transport. The Commission requires pipelines performing transportation under Section 311 to flow back to their system customers all revenues in excess of one cent per mmbtu or demonstrated out-of-pocket costs if they are higher. This flowback requirement has been retained notwithstanding vigorous protests from all sectors of the industry.2/ In issuing the

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2/ I note here that the Commission's practice in pipeline rate cases in regard to transportation service revenues has achieved the same result as to Natural Gas Act Section 7 transportation.

final regulations in August 1979, the Commission noted that it had received comments in opposition to the flowback requirement. The Commission said that it was "studying" the matter and "[a]t the completion of that study, the Commission will re-examine the necessity for providing an incentive for Section 311(a)(1) transactions." It has been three years since the Commission made that statement, and there has been no indication that the Commission or its staff has completed the study referred to. Indeed, there is no indication that such a study has even been undertaken.

AGD urges that the Congress give serious consideration to legislation which would require the FERC to provide pipelines with appropriate and reasonable financial incentives to engage in transportation services either under NGPA Section 311 or Section 7 of the Natural Gas Act. AGD is not prepared at this time to tell you what in our view would constitute "an appropriate and reasonable incentive." This, we think, would require careful study reflecting the views and comments of all interested parties. Furthermore, we do not suggest that the Congress itself should prescribe the incentives. Rather, Congress should require the Commission to do so, subject to certain guidelines, within a relatively short period of time. Once these financial incentives are in place, pipelines should be required to transport distributor's gas on a firm basis up to contract demand levels and on an interruptible basis above contract demand levels. Given the

Commission's inaction on this matter for several years, some time limit imposed by the Congress also appears to be necessary.

Another issue relating to pipeline transportation has been quite controversial over the last two years and, in AGD's opinion, has occupied an unjustified amount of time of the Commission's staff and parties to a multitude of litigated cases. I refer to the controversy surrounding pipeline transportation of producer-owned liquids and liquefiable hydrocarbons. AGD, as well as others, has taken the position that when a pipeline pays a producer the ceiling price for gas and, in addition, provides the producer with free or under-priced transportation of the producer's liquids and liquefiables, the producer is receiving a total "price" that exceeds the maximum ceiling price.

Beginning in February 1981, efforts were made to settle this issue on an omnibus basis involving virtually all interstate pipelines. Although settlement efforts continued for approximately 18 months, the end result was no settlement and the matter remains "up in the air." This issue is holding up settlement of many pipeline rate cases, is pending in at least one court appeal, and has been raised in connection with pipeline PGA filings. In addition, producers, pipelines and distributors long ago asked the Commission to institute generic proceedings to resolve the matter. While FERC has recently urged continued omnibus settlement discussions, no end appears in sight.

Accordingly, we believe it would be in the interests of all concerned for Congress to step in and clarify that, under NGPA Title I, the value of nonmonetary consideration given to producers by pipelines is considered to be part of the price paid. Thus, the monetary consideration plus the uncompensated value of nonmonetary consideration could not exceed the NGPA ceiling price.

V. Reponses To Issues Posed In The Committee Hearing Notice

1. Experience Under NGPA -- Our experience to date under the NGPA has been that its dollar impact has been extemely large and, in fact, much greater than it was predicted to be at the time of its enactment. On the good side, we are getting the benefit of improved supply, however, the price at which that supply is available is clearly excessive in relation to the expectations raised when NGPA was enacted. I would note that a Congressional Budget Office Report issued in August of 1978 estimated the total consumer impact or "wealth transfer" resulting from the NGPA at from $11 to $20 billion over the six year period from 1979 through 1984. Our review of the data compiled by DOE on actual gas prices prevailing under NGPA has disclosed that the consumer impact or dollars actually transferred in 1981 alone was very close to $20 billion on a national basis. To bring the matter in focus at the local distribution company level, I can tell you that Philadelphia Gas Works' cost of buying gas has jumped from

approximately 75 cents in 1978 to $2.75 per mcf in 1981. Today, in Philadelphia the average cost of acquiring gas at the wellhead in the producing states represents about 60 percent of our total charge for gas delivered at the burner-tip, and that percentage is growing. To summarize this point, let me say that the improved supply condition that the consumer now enjoys under NGPA has been purchased at a cost far greater than anyone expected. In terms of the changes that this situation has brought about in gas utility operations, the most notable are that we have seen our uncollectible accounts rise dramatically, as discussed in more detail below, and that we on the East Coast are already beginning to see significant amounts of industrial load loss. As our markets become more and heavily devoted to residential and small commercial customers, and less of our annual revenues come from industrial sales, we expect our winter peak demands to grow well beyond historical levels. This will create significant problems in the form of needs for additional storage facilities, capacity bottlenecks on our interstate pipeline suppliers' systems and the need for more peak shaving capacity at the local level.

2. Load Loss and Fuel Switching -- Along the East Coast, many gas utilities are in head-to-head price competition today with no. 4, no. 6 fuel oil and other competitive fuels in the industrial markets. The Northeastern utilities are also coming close to parity with no. 2 fuel oil in the residential markets, not to mention propane and electric heat pump competition.

I can tell you that my company and my colleagues in other East Coast companies feel that the "market has cleared" for many of our sales, and we are presently engaged in a very competitive environment at the burner-tip. I should also note that, to the extent gas distributors do lose load, retail prices are increased to remaining customers to recover fixed costs and, along the East Coast, oil imports rise as much of such load lost is to imported oil.

3. Market-Clearing Price for Natural Gas -- I would define market-clearing price as the price above which significant load loss would occur on a gas utility system. In a totally decontrolled market this price would vary across a wide range of competitive fuels and customer classes. These fuels include numbers 2, 4, 5, 6 (high sulphur) and 6 (low sulphur) oils, propane, coal and wood. The specific market-clearing price for gas in any specific distributor's service area would depend on the price of competitive fuels in that area and their availability. Establishing a "market-clearing price for gas nationwide" is of little value given that such a price could well leave some distributors' markets dangerously exposed.

4. Pipeline Supply Projections -- Over the near term, our major interstate pipeline suppliers have projected no significant curtailment. Indeed, there is currently a significant gas supply surplus. However, over the long-term, we continue to be concerned about the ever diminishing reserve-to-production ratios

which we see occurring on most interstate pipeline systems, though with modest improvement over the pre-NGPA period. It should be noted that the accelerated draw downs on wells caused by high take-or-pay requirements contribute significantly to the diminishing R/P ratios.

5. Uncollectibles -- It is clear that the higher than expected economic impact of the NGPA which I described previously falls more or less evenly on all gas consumers without regard to their ability to pay. This is a very difficult problem for all gas utilities particularly those in densely populated urban areas. For example, in Philadelphia, the average cost of gas sold to a residential heating customer has increased from $3.35 per mcf in fiscal 1978 to its recent level of $6.23. This means that a typical residential heating customer who had an average monthly bill of $37.00 now has an average bill of $67.00. In the winter months, a bill that was $67.00 in 1978 was $130.00 in 1981. These figures indicate that the three year net effect under NGPA has been to increase gas bills at the burner-tip by over 90 percent. These increases in consumer prices and consumer bills have brought with them an extremely serious problem for all gas distributors in the form of write-off expenses for unpaid gas bills. Simply stated, our experience with the higher NGPA-mandated prices shows that as prices go up the number of uncollectible gas bills goes up even faster. Our bad debts expense in fiscal year 1981 for Philadelphia Gas Works was some $5.4 million; for the current PGW

budget year we estimate our uncollectible account will grow to $14.8 million.

I should add that these dollars are not the entire cost. They include only the cost of gas delivered to non-paying customers, but not the additional amount of dollars used in borrowing to finance both late payments and nonpayment nor do they reflect the dollars spent on the telephone, direct mail attempts and personal visits in attempts to collect the money owed. They also do not reveal the fact that the ultimate cost of these large write-offs is borne by those customers who can and do pay their gas bills. The expense of write-offs has now become a significant item in any distributor's overall cost of doing business.

One of the factors contributing to this problem is the federal government's action in reducing fiscal 1982 appropriations for low-income energy assistance grants to the States. Whereas the energy assistance program was enacted in 1980 with an authorization of $3 billion in aid to low-income energy consumers, that program has been cut to less than $1.7 billion in fiscal 1982 appropriations law.

In sum, gas distributors are, as any other business, not ideally suited to deal with this problem, but are making every effort in every way to cope and to assist their low-income customers as well as those who ultimately pay the bill for the many uncollectible accounts. The problem of uncollectibles is, however, a societal problem, and one which should properly be treated by society at large, not gas customers or distributors. This is why the AGD companies firmly support increased low-income energy assitance program funding. We urge Congress to continue to pursue substantial low-income energy assistance programs to assist the poorest of our customers with the higher prices caused by NGPA. The energy assistance funding cuts do not "save" money; rather, the costs of uncollectibles is simply shifted from society at-large to gas distribution company customers. This is not a fair distribution of the societal responsibility and should be changed. Gas distributors and their customers cannot, alone, resolve the dilemma of low-income energy users. Congress must assist.

* * *

I appreciate this opportunity to appear before you today and present the views of the Associated Gas Distributors on natural gas pricing policy. The area is fraught with complexity and significant economic consequences for the gas consumer and the country at-large. The task is difficult, but I do hope that Congress and particularly your Committee will make every effort early in the 98th Congress to address the problems that I have raised in this statement. The Associated Gas Distributors stand ready to assist you in any way possible.

Thank you.

AGD Member Companies

Baltimore Gas & Electric Co.
Bay State Gas Co.
The Bershire Gas Co.
Boston Gas Co.
The Brooklyn Union Gas Co.
Cape Cod Gas Co.
Central Hudson Gas & Electric Corp.
City of Bowman, Ga.
City of Buford, Ga.
City of Commerce, Ga.
City of Covington, Ga.
City of Elberton, Ga.
City of Hartwell, Ga.
City of Holyoke, Mass, Gas & Electric Dept.
City of Lawrenceville, Ga.
City of Madison, Ga.
City of Monroe, Ga.
City of Royston, Ga.
City of Social Circle, Ga.
City of Sugar Hill, Ga.
City of Toccoa, Ga.
City of Union Point, Ga.
City of Westfield Gas & Electric Light Dept.
City of Winder, Ga.
Commonwealth Gas Co.
Concord Natural Gas Corp.
The Connecticut Gas Co.
Consolidated Edison Company of New York, Inc.
Delmarva Power & Light Co.
Elizabethtown Gas Co.
Fitchburg Gas & Electric Light Co.
Gas Service, Inc.
Haverhill Gas Co.
Long Island Lighting Co.
Lowell Gas Co.
Lynchburg Gas Co.
Manchester Gas Co.
New Jersey Natural Gas Co.
New York State Electric and Gas Corp.
North Carolina Natural Gas Corp.
Northern Utilities, Inc.
Pennsylvania Gas & Water Co.
Pequot Gas Co.
Philadelphia Electric Co.
Philadelphia Gas Works
Providence Gas Co.
Public Service Company of North Carolina, Inc.
Public Service Electric & Gas Co.
South County Gas Co.
South Jersey Gas Co.
The Southern Connecticut Gas Co.
UGI Corporation
Valley Gas Co.
Washington Gas Light Co.

Senator **Warner**. Thank you very much.
Mr. Cooper.

STATEMENT OF C. WILLIAM COOPER, CHAIRMAN, UNITED DISTRIBUTION COS.

Mr. **Cooper**. Mr. Chairman, we have submitted a written statement, which I would ask be made a part of the record.

Senator **Warner**. Your statement will be made a part of the record.

Mr. **Cooper**. We agree that the problems are very complex and difficult. And we would hate to see any simple, stopgap measure enacted. We would like to see a comprehensive piece of legislation that addresses the problems. We will do our best to assist the committee in any way we can to solve those problems.

We have made suggestions in our statement about how that can be done and we would encourage and request your consideration of that.

[The prepared statement of Mr. Cooper follows:]

STATEMENT OF
UNITED DISTRIBUTION COMPANIES

by
C. William Cooper, Chairman
159 Town Hall Square
Falmouth, Mass. 02540

Communications relative to this statement may be made through UDC's Washington Offices:

United Distribution Companies
Suite 1100
1111 19th Street, N.W.
Washington, D.C. 20036
(202)429-9335

Richard M. Merriman
Washington Counsel

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

United Distribution Companies ("UDC") was privileged to appear and present its views on the natural gas situation at the initial hearings held by your Committee on March 22nd and 23rd of this year.

Our statement at that time set forth the utility companies which constitute UDC, as well as the work of the group, so it will suffice, at this time, to say that UDC is an ad hoc group of 33 organizations providing over 20% of all gas utility service throughout the United States and rendering service in the following states:

Arkansas
Illinois
Indiana
Michigan
Missouri
New York
Ohio
Pennsylvania
West Virginia
Wisconsin

Our statement at the March 23rd hearing laid before your Committee a detailed study of the contractual and institutional problems of the industry, and we outlined those new statutory provisions which seemed essential for the protection of utility service and the consuming public.

Following that initial hearing, UDC completed pricing studies which show that pipeline gas purchase costs have reached and are being projected above market clearing levels to the grave detriment of utility service. We have also completed detailed impact studies demonstrating the pricing effects of indefinite price redetermination clauses and other pricing scenarios, including the decontrol of "old gas." All of those studies were laid before the Subcommittee on Fossil and Synthetic Fuels of the House Committee On Energy And Commerce at its hearings on August 6th. In the short time available for the preparation of this statement, we have been unable to include these studies herein, but copies of our statement to the House Subcommittee have been furnished to your Committee's Staff and additional copies will be provided if desired.

We again appreciate this opportunity to appear before your Committee; and turn immediately to our Summary Analysis of the problems of the industry.

I

SUMMARY ANALYSIS

Most people now agree that gas utility service and the consumers of this Nation are faced with pricing problems of growing and potentially monumental proportions.

Steadily rising costs of gas supply are thrusting rate increase after rate increase on utility service and, through it, on to residential, commercial and industrial users. Rates for many industrial services have reached or exceed market clearing levels. Major losses of load have occurred or are impending. And, all signs indicate that this process will inexorably continue.

Furthermore, when existing price redetermination and take-or-pay clauses take their toll following decontrol of new gas on January 1, 1985, the situation will be catastrophic. UDC estimates that utility loads will contract by 40% and that residential rates will rise by 350% over the next 8 years. (See Statement to House Subcommittee pages 44-45).

Since supplies are now adequate and competitive fuel prices are severely depressed, this makes no economic sense. No natural resource industry can or should operate in this fashion, or be subjected to these dangers; and this is particularly true of public utility service on which 40,000,000 households depend.

As set forth in our detailed statements to this Committee on March 23rd and to the House Subcommittee on August 6th, UDC, respectfully, represents that this abnormal and dangerous situation is being precipitated by five serious problems:

1. The steady upward escalation of NGPA ceiling prices pursuant to statutory inflationary formulae which bear no rational relationship whatsoever to the value of gas in the field;

2. Excessive costs which are and will be occasioned by extreme "take-or-pay" requirements in producer-pipeline supply contracts;

3. Exorbitant prices which will be brought about by future operation of indefinite price redetermination and favored nation clauses in producer-pipeline supply contracts;

4. Pipeline rate designs which frustrate clear transmission of the effects which rising field prices have on consumer demands for utility service; and

5. The entirely abnormal and excessive price situation resulting from the decontrol of Section 107 gas.

Legislation meeting and rectifying all five of these problem areas on a coordinated basis is absolutely essential. Indeed, if pricing forces now set in motion continue to fruition, utility service and the consumers of this Nation will be driven to the wall.

In our considered judgment, your Committee should deal with the whole natural gas situation and all its problems in comprehensive fashion through one coordinated statute. Any attempt to solve single situations, however bad, on a piece meal basis, may only set in motion other problems not now apparent and provide no long term relief for utility service and consumers.

In truth, all major pricing problems now plaguing this industry are interrelated and feed one upon another. So, we most respectfully recommend that your Committee hear and consider all aspects and recommend to Congress that comprehensive legislation which will surely set this industry on a sound course for the long term future.

To this end, UDC respectfully recommends for consideration legislation along the lines set forth in the following section.

II

SUMMARY STATEMENT
OF
LEGISLATIVE PRINCIPLES

To meet critical and escalating price and market problems now faced by utility service and the consuming public, UDC supports comprehensive natural gas legislation embodying the following correlated principles:

1. Correction of NGPA Ceiling Prices.

NGPA embodies formulae which steadily escalate ceiling prices in ways which bear no relation to the course of competitive fuel prices; and, in consequence, prices for natural gas are being inexorably carried to and above market clearing levels. This is contrary to sound resource economy. To meet this critical problem, the new statute should provide

(a) that ceiling prices shall be reduced at date of enactment to those which would have been in effect had original 1978 ceiling prices been escalated in annual increments in accord with annual changes in prices of low sulphur No. 6 oil, the most sensitive competitive fuel--subject to a maximum annual change in each year based on the NGPA formula;*/

(b) that such reduced prices shall, thereafter, be revised annually--either up or down--in accord with future annual changes in the price of such competitive fuel--again, subject to a maximum based on the NGPA formula;*/ and

(c) that the Commission shall determine and publish such revised ceiling prices.

2. Correction of the "Contracts Problem" i.e., Price Redetermination and Take-or-Pay Clauses.

Indefinite price redetermination and favored nation clauses in producer-pipeline contracts will inexorably force gas prices far above market clearing levels to inordinate and destructive heights. So, too, excessive take-or-pay requirements in producer-pipeline contracts cause inefficient and unsound supply operations, unreasonably inflate average costs of gas and can, in periods of low demand, cause serious financial problems.

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*/ Note: Section 102 and 108 gas would receive the additional 4% provided by NGPA.

Action as to these contractual practices must be taken and sound means must be provided for periodically redetermining prices and arriving at sound take-or-pay provisions. To these ends, the statute should provide:

(a) that all indefinite price redetermination and favored nation clauses of the kinds presently in use and as comprehensively defined in the statute--(excepting, however, "area rate clauses" of the kind heretofore approved by the Commission)--shall be outlawed and nullified in and for both existing and future contracts;

(b) that the public interest requires that take-or-pay clauses achieve a proper balance between the producer's reasonable needs for cash flow and reserve protection, on the one hand, and the need of the market for flexibilities essential to sound operations and variations in demand;

(c) that, to provide means through which sound periodic price redeterminations and sound take-or-pay requirements shall be achieved, both the producer and the pipeline shall, each, have the right to require renegotiation of prices and/or take-or-pay requirements at stated intervals, and that, as so renegotiated, the new contractual terms shall supplant the old;

(d) that if, after a period for renegotiation, the parties shall have failed to agree upon new terms for the issues being renegotiated, the contract may be terminated by the dissatisfied party, whether pipeline or producer;

(e) that, if the producer so terminates, it may seek another pipeline purchaser for the subject gas; but, the pipeline which has been a party to the terminated contract shall have the right of first refusal of the gas at the price tendered to the producer by such other pipeline purchaser;

(f) that, if any contract is so terminated by a producer and the right of refusal is not exercised, the pipeline shall, to the extent possible, arrange transportation for the producer's supply to the new pipeline purchaser; and

(g) that, to insure sound contractual practices on the part of interstate pipelines, the Commission shall, in its rate regulation, regularly review the prudence of pipeline gas supply planning and contracting as a condition to the full recovery of carrying charges associated with prepaid gas costs.

3. Pipeline Rate Designs.

Because existing pipeline rates and rate designs frustrate free transmission of demand and price tolerances of utility service to pipelines and producers, the new statute should provide as follows:

(a) that the Commission shall promulgate, within 12 months, pursuant to the Natural Gas Act, new rules which require pipeline rates and rate designs to be so modified that the demand and price tolerances of the utility market may be freely reflected in varying takes of field supply as such and, hence, that, as field prices rise and utility service demands fall in consequence, payments of costs associated with field supply not taken would likewise fall;

(b) that these new rules shall be reported to Congress when issued, accompanied by a full report;

(c) that, unless modified by further Congressional action, the Commission shall take all steps necessary to insure that new rate designs mandated by the rule are filed and take effect within 12 months following issuance of the rule; and

(d) that Section 601 of NGPA shall not be construed or applied in any way which would limit the establishment or approval of pipeline rates or rate designs under which high cost gas supplies will be tested in the market place.

4. Postponement of Decontrol of New Gas Until New Pipeline Rate Designs Take Effect.

Since new pipeline rate designs are critical to the successful marketing of gas in close competition with other fuels, the new statute should provide as follows:

> that Section 121 of NGPA is amended by changing the decontrol date of January 1, 1985, to that later date on which the new pipeline rate designs, developed pursuant to Point 3 above take effect.

5. Decontrol of Certain New, New Reservoirs.

The new statute should decontrol, at date of enactment, "new, new" reservoirs falling within the scope of Section 102 of NGPA--to the end that, as these new reserves of gas come on line under current competitive and surplus supply situations, an enlarged group of arms length negotiated prices for many types of new wells (not just Section 107 wells) will come into being, and a sound market will be established in advance of general new gas decontrol.

6. Maintenance of Ceilings on Old Gas.

The new statute should reaffirm the policy of NGPA that ceiling price controls on "old" gas--(i.e., primarily pre-NGPA gas covered by Section 104)--shall continue indefinitely. This is necessary for the following basic reasons:

Decontrol of old gas must have as its intent and purpose an equalization of prices for all classes of gas, just as posted prices for crude oil are generally uniform, regardless of the age of the well.

But with average gas purchase costs of pipelines now standing at or above market clearing levels, equalization could be accomplished only through the roll back of prices for new gas. But this flies in the face of both economic realities and producer expectations.

Old gas was drilled for and brought on line when costs were much lower and when producers were fully aware that their prices would be regulated. New gas, on the other hand, was drilled for in times of higher costs and was brought to market only on the strength of higher prices and in the expectation of ultimate decontrol.

UDC impact studies show that raising prices for old gas to market clearing levels would depreciate prices which could be paid for future reserves to such low levels that future exploration and development would be frustrated.

III

FURTHER DISCUSSION OF INDUSTRY PROBLEMS AND RECOMMENDED STATUTORY SOLUTIONS

A. NGPA Ceiling Prices.

NGPA ceiling prices ratchet upward month by month in accordance with a formula keyed to a general pricing index which bears no relation to trends in competitive fuels or field resource values or the willingness of the market to pay prices equated to these ceilings.

Under most contracts, pipelines pay prices keyed to the statutory ceilings and, in consequence of this upward statutory ratchet, average gas purchase costs of pipelines have already been forced to market clearing levels. If the process continues unabated costs will be forced far above market clearing levels with disastrous consequences.

Furthermore, as prices for gas covered by ceiling prices continue upward above normal resource values, less can be paid for new resources in the future, with tragic consequences upon necessary new exploration and development. Schedule 2 to Appendix B to UDC's Statement to the House Subcommittee demonstrates that if prices for old gas are inexorably ratcheted upward above market clearing levels, prices which can be paid for essential new reserves are depreciated to ridiculous levels.

Changes in statutory ceilings should be related to changes in the costs of competitive fuels, since resource values in the field are necessarily related to competitive fuel prices. Appendix C to UDC's Statement to the House Subcommittee demonstrates how far the statutory formula has caused ceiling prices to exceed levels shown to be proper by trends in the price of low sulphur No. 6 oil -- the most sensitive competitive fuel.

In all reason, the NGPA ceiling price formula must be corrected, and UDC proposes that this be accomplished by an amendment which relates changes in ceiling prices since inception in 1978 to changes which have occurred and will occur in prices for low sulphur No. 6 oil. We have provided that the statutory formula continue to be used in any year of abnormal and excessive changes in the price for No. 6 oil, such as might occur if there were an OPEC oil embargo.

Some persons contend that the way in which to rectify ceiling price errors in NGPA is to deregulate all gas and thereby nullify the ceilings. It is said that prices would immediately drop to market clearing levels and remain there. We would call attention to the fact that this would necessitate the elimination of all existing supply contracts and cast the industry adrift on an uncharted sea in which all prices for new gas would be rolled back.

UDC believes that the more conservative course is to bring the ceilings into line with reality.

B. The "Contractual Problem."

1. Indefinite price redetermination and favored nation clauses in producer-pipeline contracts.

Periodic adjustment of stated prices in long term contracts is a necessary and customary practice in these days of economic uncertainty; and contractual provisions adjusting the price to fair market value as it moves up and down are just and reasonable.

But, indefinite price redetermination and favored nation clauses in producer-pipeline contracts represent a momentous problem. Through the domino effect of these clauses acting one upon another, field prices for decontrolled gas will be carried to arbitrary amounts far above market clearing levels. Moreover, this is a one-way ratchet, since adjusted prices, once up, do not come down, even though those economic indicators which initially gave rise to the increase have come down.

These clauses and their destructive potential are discussed in detail in UDC's March 23rd statement to this Committee and in our statement to the House Subcommittee. We show in the latter statement that, by ratcheting field prices of gas up to the level of No. 2 oil in the marketplace, existing contracts will cause utility service to lose 40% of its load and project retail rates upward at the rate of 40% per year. Nothing more exhorbitant or overbearing could possibly be imposed upon the industry.

Various ways of dealing with this problem are being suggested and UDC has considered more than one in its deliberations. On the whole we believe that the surest way of conforming prices to values during the term of a contract will be through periodic renegotiation in the manner set forth in the legislative principles offered above.

2. Take-or-pay provisions in producer-pipeline contracts.

Take-or-pay clauses in producer-pipeline contracts are legitimate when they serve the sole purpose of affording to the producer reasonable cash flow and protection against drainage of reservoirs.

But, the excessive take requirements in many existing contracts (80%, 90% or even 100% of daily deliverability) go far beyond these legitimate ends. They are causing the preferential taking of high cost gas, and consequent shutting in of lower cost gas, the very reverse of normal occurrences in a natural resource industry. In short, they unreasonably inflate average gas costs and cause inefficiency and waste. In periods of very low demand or major load loss, they hold promise of bankrupting the purchaser. We develop these problems in detail in our Statement of March 23rd and in our Statement to the House Subcommittee.

Many persons now recognize the magnitude of this problem and various solutions are being offered.

For many prior months, UDC believed that the best method of handling the matter lay through contractual standards mandated by Congress and developed in rules issued by the Federal Energy Regulatory Commission or some other agency. We so recommended in our Statement of March 23rd and in our Statement to the House Subcommittee. But mature consideration now impells us to recommend, as set forth in the foregoing statutory principles, that take-or-pay requirements be brought into line through periodic renegotiations and accompanying termination rights, if reasonable provisions cannot be achieved.

C. Pipeline Rate Design.

Interstate pipelines are selling gas to distribution utilities and to one another pursuant to filed tariffs which have, in most instances, grown up during many years of regulation under the Natural Gas Act. By and large, the forms of rate used in these tariffs grew up in earlier days when natural gas prices in the field were far below competitive market clearing levels. Under these circumstances, minimum take and other operating requirements in the tariffs offered no problem to utility service and little attention was paid to the exact terms of minimum bill and related provisions.

But, field prices have now pushed average pipeline gas purchased costs to market clearing levels and utility service enters upon a new era in which user demands and price limitations must play a direct part in determining values of gas in the field.

The marketability of new field supplies is now of primary concern to utility service and must be made a primary concern to both pipelines and producers. For utility service is now choking on the results of contracts entered into without due consideration of this fundamental economic law.

In this new era, the realities and demand/price tolerances of utility service must determine resource values in the field, just as markets determine the value of all natural resources--oil, coal, metals or lumber. There must be a very careful balancing of demand and supply. Long term supply must be secured for utility service; yet it can bear no more than marketable prices.

Yet the free communication of these realities--these market signals--is frustrated by minimum bill, take requirement and other elements of existing rate design. The effects which demand/price tolerances of utility service should have on field prices cannot occur.

This problem must, of course, be settled in proceedings before the Commission under the Natural Gas Act, but it is imperative that Congress assert that the subject shall be studied and necessary new rules promulgated. Legislative proposals to this end are presented above.

D. Postponement of the Decontrol of Existing New Gas Until the Foregoing New Rules of Pipeline Rate Design Take Effect.

Section 121 of NGPA provides that most "new" gas--(i.e., gas brought into interstate commerce following passage of NGPA)--shall be decontrolled on January 1, 1985. But it is obvious that this should not and cannot occur until new rules of pipeline rate design take effect. For only when that happens can the market be assured that its reaction to changes in gas prices following decontrol will be rapidly and effectively communicated to both pipelines and producers.

To this end, we recommend above that Congress amend Section 121 of NGPA by changing the decontrol date of January 1, 1985, to that later date on which the new pipeline rate designs, developed and placed in effect pursuant to Section C above take effect.

E. Immediate Decontrol of Certain New, New Reservoirs.

While ceiling price controls on new gas in general should remain in effect as above provided, development of a sound, long term market in field supplies will be advanced if certain "new, new" reservoirs brought into interstate commerce for the first time following date of enactment are immediately decontrolled. Since supplies of gas are now adequate and pipeline average gas costs are at market clearing levels, initial prices negotiated for these new reserves should represent fair market values--far different from abnormal prices so far seen in the limited market for Section 107 gas. The results should provide an array of decontrolled prices for a variety of wells and, hence, a sound established market should be in place when all other new gas is decontrolled as above provided.

To this end, the decontrol sections of NGPA should be supplemented with a new section which decontrols new reservoirs from which natural gas had not entered the interstate stream prior to enactment and for which arms length sales prices are negotiated following date of enactment.

F. Continuation of Ceiling Price Controls on Old Gas, Subject to the Modifications Specified in Section A Above.

NGPA policy is that ceiling price controls on "old" gas--(i.e., primarily pre-NGPA gas covered by Section 104)--shall continue indefinitely; and this differentiation between new gas and old gas is believed to be sound.

The rationale for this recommendation is briefly set forth as part of our statutory recommendations in Section II above. But the subject is developed in much greater detail in our statement to the House Subcommittee on August 6th, to which we respectfully refer.

We call attention in particular to the overall cost increases there shown and, in consequence, to the depreciation in prices which can be paid for essential new exploration and development,--and, hence, the depreciation of long term supply.

CONCLUSION

In conclusion, we most respectfully recommend that your Committee enter upon comprehensive hearings into these critical problems and essential solutions as early as possible in the forthcoming new Congress, to the end that comprehensive legislation setting this plagued industry on a sound, long term course will be promptly enacted. In such hearings UDC will seek the privilege of presenting for your consideration extensive economic and pricing studies along the lines heretofore presented to the House Subcommittee.

Respectfully submitted,

UNITED DISTRIBUTION COMPANIES

By: William Cooper
Chairman

Senator WARNER. Thank you, Mr. Cooper.

Mr. Elam.

STATEMENT OF JACK ELAM, VICE PRESIDENT, CONE MILLS CORP., ON BEHALF OF THE PROCESS GAS CONSUMERS GROUP, ACCOMPANIED BY EDWARD J. GRENIER, JR., SUTHERLAND, ASBILL & BRENNAN

Mr. ELAM. Mr. Chairman, I am Jack Elam. With me is Ed Grenier of the firm of Sutherland, Asbill & Brennan.

No. 1, remove wellhead price controls from all natural gas as of January 1, 1985.

No. 2, encourage producers and purchasers voluntarily to renegotiate their existing contracts and facilitate such renegotiation.

No. 3, repeal the incremental pricing program, NGPA, title II, and the Power Plant and Industrial Fuel Use Act.

No. 4, provide for the mandatory filing with the FERC of all natural gas purchase contracts and make them available for public inspection.

No. 5, provide expanded access to natural gas supplies by all pipelines, distribution companies and end users.

Finally, any gas reform legislation should not include any so-called windfall profit tax on natural gas.

Thank you, sir.

[The prepared statement of Mr. Elam follows:]

TESTIMONY OF
JACK ELAM
ON BEHALF OF
THE PROCESS GAS CONSUMERS GROUP

STATEMENT OF THE PROCESS GAS CONSUMERS GROUP

I am Jack Elam, Vice President of Cone Mills Corporation, appearing here on behalf of the Process Gas Consumers Group. Appearing with me is Edward J. Grenier, Jr., of the law firm of Sutherland, Asbill & Brennan in Washington, D. C.

The Process Gas Consumers Group (PGC) is an organization of industrial consumers of natural gas with member companies who own and operate hundreds of plants in virtually every state and purchase natural gas directly or indirectly from both interstate and intrastate pipelines, with most of our facilities on the interstate system.

I. STATEMENT OF POSITION

While the range of uses in which PGC members use natural gas is quite broad, PGC's views with respect to natural gas issues reflect primarily its members' use of natural gas in industrial processes in which alternate, non-gaseous fuels cannot reasonably be utilized. From this perspective, there are two paramount natural gas issues: (1) security of supply and (2) price. The first issue involves primarily the matter of reliability -- consumers' ability reasonably to depend upon their suppliers to satisfy their gas requirements. The second issue encompasses not only price levels vis-a-vis alternate fuels, but also the effects of pricing policies and rate design on the relative rates paid by various classes of gas consumers.

their suppliers to satisfy their gas requirements. The second issue encompasses not only price levels vis-a-vis alternate fuels, but also the effects of pricing policies and rate design on the relative rates paid by various classes of gas consumers.

PGC's concern with supply security may seem to some to be unwarranted, particularly during this period when (1) interstate pipelines appear to be madly scrambling to find ways to dispose of their excess gas supplies, and (2) we are repeatedly told that the United States' conventional gas resource base remains sufficient to meet current levels of demand for several decades. However, neither current supply surpluses nor these gas resource forecasts give industrial users any significant comfort.

The promising supply forecasts by and large assume the existence of a free market at the wellhead and, thus, prices for gas which in fact approximate its "market-clearing" price. Today, however, the partially-regulated "market" under the NGPA is characterized by wildly disparate prices -- some far below "market clearing" and others absurdly above it. Some pipelines already face real industrial load losses as they purchase expensive supplies under strict take-or-pay provisions and turn away cheaper supplies. High-cost supplies are being produced before lower-cost supplies, further depressing demand and distorting the signals sent back to producers as to future gas needs. Thus, so long as substantial volumes of natural gas remain subject to distorting price controls -- which insulate gas prices from the realities of the market and inexorably push some prices higher while others remain artificially low -- industrial users are not comforted by large estimates of conventional domestic gas resources which are producible at reasonably stable, free market prices. PGC is confident that the free market -- not "quick fix" tinkerings with the current scheme -- will work to produce those resources and bring supply and demand into balance. But, until such a free market exists, PGC has no such confidence in long-term gas supply reliability.

The same observations may be made with respect to the gas surpluses currently being experienced in some parts of the country. PGC believes that such surpluses are in part the product of the unstable conditions which have been fostered by the Natural Gas Policy Act of 1978 (NGPA). The perpetuation of such conditions is no basis upon which to make energy policy, and such conditions are inimical to restoring industrial user confidence in the gas market's ability stably to meet their long-term needs.

PGC's concern with supply security, of course, does not reflect industrial users' willingness to pay any price for such reliability. However, while we are no more anxious than anyone else to see our gas bills increase, we are ready and willing to pay true free-market prices for gas because we anticipate that such prices will be more stable -- and lower in the long run -- than would be the case under the NGPA. We also believe that such free-market prices will be lower than the costs that we (and the Nation) will incur if energy policy regresses to the reimposition of price controls with the attendant risks of renewed supply shortages and resultant economic and social dislocations.

Thus, PGC believes that wellhead price controls must be removed if supply and demand in the gas market are ever to be brought into balance. However, we must emphasize that, while we are willing to pay free-market prices for gas, we are strongly opposed to (1) paying prices higher than those which would be commanded in a truly free market, and (2) paying a disproportionate share of higher gas costs so that other gas consumers can be subsidized, such as through so-called incremental or marginal cost-based pricing schemes.

As consumers, we are concerned about the impact of higher gas prices on our businesses, our customers, and our employees. But it is precisely that concern which leads PGC to support comprehensive legislation to deal with the serious defects in the NGPA and the resulting harmful distortions in natural gas markets. PGC does not believe that its goal of obtaining adequate gas supplies at reasonable prices will be achieved under the NGPA in its current form. But, even more important for purposes of today's hearing, we do not believe that the kinds of partial, stop-gap "solutions" which are currently being proposed are solutions at all. The temptation to attempt to deal only with portions of the natural gas problem is indeed strong, but the risks are high that the problem will only be exacerbated if Congress yields to that temptation. In our view, half a loaf in these circumstances is worse than none.

For the reasons discussed below, therefore, PGC respectfully urges that the Senate decline to adopt the kind of myopic, "quick fix" proposals which have recently been advanced and, instead, turn its attention to consideration of natural gas legislation which will deal boldly and comprehensively with the problems now facing the gas industry and gas consumers. Now is the time to take steps to get us out of the mess created by the NGPA. Congress must resist the temptation to adopt superficial measures which will only sink us deeper into that mess.

Set forth below are PGC's comments on certain of the gas legislation proposals which have recently been introduced or circulated. Following those comments, PGC sets forth in broad outline the elements of comprehensive gas legislation which it believes should be endorsed by this Committee and enacted expeditiously.

II. COMMENTS ON PENDING LEGISLATIVE PROPOSALS

PGC approaches the current natural gas crisis as industrial gas users who pay the bills. We also approach the situation as manufacturers who need assurances that natural gas -- as well as all other forms of energy -- will be available for us to purchase in the quantities we need and at prices we are willing to pay. Without that kind of long term energy market stability, we cannot rationally plan the investments we need to make to get this country's economy solidly back on its feet for good. Unfortunately, price regulation at the wellhead is anathema to stable prices and supplies. The Natural Gas Act produced shortages, and the NGPA is producing the current mess.

Consequently, PGC opposes adoption of myopic bills which would simply tinker with the NGPA's misguided scheme of price controls in the hopes of extending their operation. Now is the time to stop trying to run the marketplace from Washington and to call an end to all wellhead price regulation once and for all. Price regulation didn't work for oil; it didn't work for the economy as a whole; and it isn't working for natural gas.

With respect to the bandaid bills which have been introduced or are being circulated in draft form, each is seriously flawed. Each will produce serious adverse consequences in both the short and long term, and each will have your constituents back at your door in relatively short order.

A. The Eagleton Amendments

According to their letter to colleagues dated December 8, 1982, Senators Eagleton and Danforth are proposing two pieces of legislation:

Amendment No. 1 -- Take-or-Pay Ban

Briefly stated, Amendement No. 1 would prohibit take-or-pay clauses in all contracts for the first sale of natural gas, except to the extent the FERC permits take-or-pay clauses in particular contracts (entered into prior to December 1982) to retake effect. The FERC could permit take-or-pay clauses to take effect only in order to prevent default of a loan or to prevent an unconstitutional taking of property. Contracts entered into after December 1, 1982 could never have a take-or-pay clause. Amendment No. 1 would also add "imprudence" to NGPA Section 601(c)(2), as an additional basis for the FERC to block passthrough of a pipeline's gas costs.

There are several obvious flaws in this proposal:

1. Although PGC agrees that pipelines' take-or-pay obligations are unreasonably high in many contracts negotiated under the NGPA, PGC also recognizes that take-or-pay clauses provide producers (particularly independents), with some income stability and the cash flow needed to finance new exploration and development. Adopting this measure would, therefore, cause an immediate reduction in exploration and development and then eventual shortages. Inevitably, industrial users will be the first to bear the brunt of those shortages; but everyone will feel them next in the form of layoffs and possible plant closings.

2. Senator Eagleton's Amendment No. 1 would be a boon for foreign gas producers, who would be exempt from the ban on take-or-pay (or minimum bill) clauses. Because it would not apply to gas imports, Amendment No. 1 would thereby (a)

penalize domestic gas producers, and (b) increase imports of higher priced foreign gas. Algeria, Canada, and Mexico will be the big winners.

3. Rising gas prices would be another by-product of producers' loss of cash flow stability and tightening markets under Amendment No. 1. In exchange for the added risk, producers would demand higher sales prices to justify their investment in exploration and development, and the tighter markets would enforce those demands for higher prices. (If the price freeze in Amendment No. 2 were also enacted, then domestic producers would be denied the higher prices, but foreign gas sellers would be able to get still higher prices). All consumers would feel the pinch of the higher gas prices, especially those users who cannot feasibly switch to alternate fuels. The latter group would end up with a double blow: forced to pay both the higher charges commanded by producers plus a larger share of the pipelines' and distributors' fixed costs as load drops off.

4. Although no one will know for sure until it is too late, it is possible that many producers and royalty owners of "old" cheap gas may also be hurt by this proposal. Because their investments in the wells are oldest, they may be the most likely to have paid off any debts and, therefore, the least likely to qualify for the proposed exemption to the take-or-pay ban. If it is mostly new wells that qualify for the

exemption, then the bill may not achieve its goal of lower prices even in the short term.

5. Totally free of take-or-pay obligations, pipelines would be placed in a strong position to favor their own gas production affiliates at the expense of independent producers. In the long term, consumers could be seriously hurt by legislation which in this way adversely affected competition in the gas fields.

6. The proposal would create an administrative nightmare as thousands of applications are promptly filed to obtain exemptions from the bill's ban on take-or-pay clauses. Thousands of evidentiary hearings on the relevant contracts, loan agreements, current and projected sales levels, and possible injuries would be required. These problems would be compounded by ambiguities in the bill, and the possibility that a producer could even demand a hearing concerning a particular contract more than once due to changes in the pipeline's purchasing practices.

Amendment No. 2 -- Price Freeze

Amendment No. 2 proposed by Senators Eagleton and Danforth would freeze, until January 1, 1985, the maximum lawful prices ("MLP") on all price-regulated gas at the level prescribed by the NGPA on August 31, 1982. In the case of gas which is not subject to an NGPA price ceiling (and which comes from wells in which drilling began before December 2, 1982), Amendment No. 2

would prescribe as an MLP the price being paid on August 31, 1982 (or, if none was then being paid, the average price of gas from the three nearest wells in the same NGPA category). All deregulation dates in the NGPA would be pushed back by two years.

Like Amendment No. 1, this price freeze amendment would be very harmful.

1. Freezing prices at the August 1982 level would be an invitation, if not an order, for renewed gas shortages. It would severely undermine exploration and development for new reserves and, at the same time, send a signal to users to increase consumption. Remember that, overall, reserves have declined since passage of the NGPA. In addition to the freezing of incentives and the gradual erosion of the MLPs by inflation, Amendment No. 2 would send a message to producers that Congress cannot be trusted to fulfill even its limited commitment to deregulation and that permanent regulation might occur.

2. By statutorily freezing prices, this bill would be even more rigid than the Natural Gas Act's wellhead price controls. There would be no chance for price revisions to meet changed circumstances until a new crisis forced Congress back into the picture.

3. As with the take-or-pay proposal, the freeze would apply only to domestic supplies. Imports from foreign sources would be exempt; and Algeria, Canada, and Mexico would be able to raise their prices.

4. Freezing prices at current levels would mean that many areas of the country would continue to suffer from above-market prices caused by existing gas contracts. To this extent, the proposal would extend the NGPA's "contract problem." It will not resolve it.

B. The Kassebaum Bill (S. 3054)

Senator Kassebaum's bill (S.3054) ("to amend the Natural Gas Policy Act of 1978, and for other purposes") would freeze the maximum lawful prices for all first sales of natural gas and postpone the NGPA's deregulation schedule for two years. It would operate in basically the same way as Senator Eagleton's Amendment No. 2. It would also authorize the FERC to rescind, annul, or modify take-or-pay contract provisions in "any gas sales or purchase contract" to the extent the provision "prevents the purchaser from responding to the demands of customers or other market forces." In addition, Senator Kassebaum's bill would require the FERC to adopt and implement incentive rate mechanisms for all interstate pipelines within 90 days of enactment; and it would add "imprudence" to NGPA Section 601(c)(2)'s "fraud, abuse or similar grounds" standard.

1. Like Senator Eagleton's two amendments, Senator Kassebaum's bill would devastate gas exploration and development, and it would inevitably lead to supply curtailments to gas consumers. Faced with frozen prices, a loss of take-or-

pay commitments, and the appearance that Congress will keep extending controls, domestic producers would slash their exploration and development budgets. Significant gas curtailments could begin quickly in some areas of the country and adversely affect meaningful economic recovery.

2. Being exempt from the price freeze, foreign gas suppliers would be able to capitalize on the prospect for U.S. shortages by raising prices, as they did in the pre-NGPA era.

3. The rigidity of the price freeze proposal would quickly force Congress back into the natural gas issue, perhaps by 1984 or 1986. (The NGPA took only four years to require reopening, and a freeze on all prices would have even more disastrous effects than the NGPA).

4. By applying to "any contract for the sale or purchase of natural gas," the take-or-pay provisions of Senator Kassebaum's bill would also reach contracts between intrastate pipelines and their customers and contracts between distributors and their customers. This would authorize the FERC to override state authorities and extend the power of FERC into areas traditionally left to the states.

5. The bill's standard for FERC review of take-or-pay (or minimum bill) clauses is also defective. (a) If read literally, it could ban all minimum bill and take-or-pay clauses because, by definition, all such clauses restrict the buyer's ability to respond to customers' demands by forcing the

buyer to pay for such gas when cheaper gas might then be available or when its markets cannot absorb the volumes. (b) It is unclear what "demands of customers" a seller is supposed to respond to and whether that includes both direct and indirect customers. (c) The bill's standard is one-dimensional and leaves no room for balancing public interest considerations.

6. The rule requiring implementation of an incentive rate scheme for all pipelines within 90 days may not be practicable.

C. The Northeast-Midwest Coalition's Bill (S.3076)

The bill prepared by the Northeast-Midwest Coalition and introduced by Senator Specter (a) would suspend until November 1, 1983, all take-or-pay clauses in all contracts for the first sale of natural gas, (b) would declare that a pipeline's failure to acquire the cheapest possible mix of supplies on any given day is grounds for blocking gas cost passthrough ("fraud, abuse or similar grounds"), and (c) would impose a monthly reporting and rate adjustment obligation on all interstate pipelines.

1. Notwithstanding the initial one-year term, the bill would be a guarantee of further legislative battles over extensions shortly before November 1 of each year. Because the Northeast-Midwest bill would create new market distortions,

the debates each year would involve a host of additional proposals to tinker further with the NGPA.

2. As with the bills discussed above, abolition of take-or-pay requirements would (a) severely harm incentives to undertake exploration and development, (b) compound drainage problems faced by some producers, (c) enable pipelines to discriminate in favor of their own production affiliates at the expense of competition in the gas fields, and (d) lead to eventual supply shortages.

3. The rule that the cheapest gas must be purchased first on each day would be extremely complicated and expensive to implement. It would require many pipelines to adopt complex new operating procedures and to install expensive metering equipment (which ratepayers would pay for). It would inevitably lead to extensive litigation.

4. Foreign producers would be the big winners, since the bill's suspension of take-or-pay obligations applies only to first sales by domestic producers. Further, although the cheapest-first rule applies to all purchases by interstate pipelines, that rule would not affect exporters of gas to the United States since pipelines would have to pay for the foreign gas under take-or-pay (or minimum bill clauses), even while the cheapest-first rule would prohibit them from actually taking the foreign gas. To this extent, U.S. consumers served by pipe-

lines that receive imports would be forced by the Northeast-Midwest bill to bear the costs of both the foreign take-or-pay obligations (for gas they are prohibited from taking) and the cheaper domestic gas which the pipeline is required to purchase.

5. The last sentence of Section 4(b) of the bill is unclear. It seems to exempt renegotiated contracts from the "cheapest-first" rule. While the exemption for renegotiated contracts is presumably intended to encourage renegotiations, it is unclear that it would have that effect. The only real incentive for pipelines to renegotiate would be the risk that the take-or-pay ban would not be extended; and the incentive for producers to renegotiate would be the risk that the take-or-pay ban would be extended. Whether those political risks would be adequate to induce renegotiation is unclear.

III. PGC PROPOSAL FOR NATURAL GAS LEGISLATION

In their "Dear Colleague" letter of December 8, 1982, Senators Eagleton and Danforth cite the economically illogical fact that "a substantial surplus of gas on the market" is currently accompanied by significant gas price increases and the shutting in of large volumes of lower-cost supplies. They comment on this situation: "At the time of passage of the Natural Gas Policy Act, no one anticipated this kind of breakdown in the operation of the free market."

While PGC certainly agrees that it was not anticipated in 1978 that such inconsistent economic events could occur simultaneously, PGC vigorously disagrees with the premise that these events have resulted from a breakdown in the operation of the free market. The NGPA did not create a free gas market, and the Nation's sad experience under the NGPA teaches us nothing about how free markets operate. At best, the NGPA has taught us that a part-regulated/part-deregulated "market" severely distorts the exploration and development, distribution, and price of natural gas; causes rapidly rising wholesale and retail prices without inducing corresponding increases in gas supplies; produces surpluses in some locations and shortages in others; and contributes to the demand for energy imports, such as exhorbitantly priced LNG from Algeria.

In short, the free market has not broken down; the mess in which we currently find ourselves is simply the result of gas producers, pipelines, distributors, and consumers all attempting to pursue their legitimate self-interests and fulfill their obligations in a hopelessly-confused pseudo-market. While perhaps no one could have predicted in 1978 that things would go as far awry as they have, Congress' failure to deregulate natural gas at that time could reasonably have been expected to deprive the gas market of the flexibility needed to respond to dynamic and unforeseen changes in the economy, oil prices, and other factors bearing on gas supply and demand.

PGC believes that it is time to give the market a chance to work. Therefore, in order to increase the stability of the gas industry, enhance service to gas users, hold down prices for all consumers, avoid future supply shortages, and eliminate the market distortions caused by the NGPA, PGC advocates the adoption of comprehensive gas legislation containing the following key provisions:

(1) Remove wellhead price controls from all natural gas as of January 1, 1985. For the reasons discussed in greater detail in Section IV of this testimony, PGC believes that deregulation of all gas, in contrast with NGPA-type deregulation of only some gas or the reimposition of price controls, is the prime element of a package that would produce the fairest and most economically efficient solution to the problems confronting the Nation's gas markets. Any effort to retain controls on some or all categories of supplies will inevitably yield market distortions analogous to those experienced under the Natural Gas Act and the NGPA.

(2) Complete deregulation of wellhead prices must be accompanied by a market-oriented resolution of the much-discussed "contract problem." */ PGC recognizes that extreme

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*/ PGC's view of the so-called contract problem was discussed in detail in the Group's supplemental testimony filed with this Committee on January 8, 1982, and in the Group's testimony before this Committee on March 23, 1982.

contract terms which were induced by the NGPA's scheme of partial regulation will have to be modified if the transition to deregulation is to be effectuated smoothly and successfully. While many suggestions have recently been aired as to how the contract problem should be resolved, PGC favors the type of approach which would encourage producers and purchasers voluntarily to renegotiate their existing contracts and which would facilitate such renegotiation. PGC believes that such an approach is preferable to others which have been suggested both (1) because it best simulates the operation of a free market immediately even though the transition to a fully free market is still in progress, and (2) because, in contrast with complicated caps and contract clause conversion options, this approach is straightforward, easy to understand and, therefore, easier to implement without extensive regulatory (and judicial) oversight.

(3) Repeal the incremental pricing program (NGPA Title II) and the Powerplant and Industrial Fuel Use Act. As discussed in our March 23 testimony, we believe that repeal of these measures should be accomplished in such a way that their effects cease immediately.

(4) Provide for the mandatory filing with the FERC of all natural gas purchase contracts between producers and pipelines and make such contracts available for public inspection.

(5) Provide expanded access to natural gas supplies by all pipelines, distribution companies, and end-users.

Finally, any gas reform legislation should not include any so-called "windfall profits tax" on natural gas. The concept of taxing away so-called "windfall" profits is fundamentally repugnant to PGC members. Regardless of when and how natural gas is decontrolled, natural gas producers should be permitted to charge and retain the full free-market price of such gas.

IV. FURTHER COMMENTS ON THE NEED FOR FULL DECONTROL

A. Experience With Partial Wellhead Price Controls

The relative desirability of total wellhead price deregulation is most obviously demonstrated by the miserable experiences this Nation has had with partial regulation of wellhead prices. Under the Natural Gas Act, wellhead purchases by interstate pipelines were regulated, while purchases by intrastate pipelines were not. Nearly a decade of interstate gas shortages resulted, while the intrastate market demonstrated that the free market works.

In contrast, while it extended regulation to the intrastate market, the Natural Gas Policy Act simultaneously deregulated wellhead prices for natural gas in certain categories, and it will deregulate other major categories of gas in 1985 and 1987. This partial deregulation structure has had the unfortunate results of (1) triggering exorbitant (cushion supported) prices for narrow categories of Section 107 gas and (2) creating a potentially explosive set of contract terms for gas to be deregulated in 1985. Already, contracts for deregulated gas have created serious and growing market losses for some pipelines. In 1985, when several times as much gas will be deregulated, the results could be highly destructive.

This so-called "contract problem" results from widespread gas purchase contracts containing both (1) indefinite pricing clauses which link deregulated natural gas prices to the highest gas prices being paid in a defined area or to the price of other fuels, such as No. 2 fuel oil, and (2) take-or-pay clauses which require pipelines to pay for 85%-90% of tendered supplies even if there is no resale market. (Extreme "definite" pricing clauses, which begin from a high floor and escalate according to inflation or to fixed percentages, are also serious problems in some contracts).

These problems would be resolved if we moved to a totally deregulated environment at the wellhead, while taking steps to undo the contract distortions created by four years of partial regulation under the Natural Gas Policy Act and by many pipelines' imprudent gas contracting practices. Moreover, in a deregulated environment, supply and demand would be kept in balance and the severe problems of the past would not recur.

B. Uneven Distribution of the Cushion

Deregulation of all gas, as opposed to NGPA-type deregulation of only some gas, will put all pipeline purchasers of natural gas on a relatively equal footing, with all having to compete with other energy sources available to consumers. Most obviously, elimination of the so-called "old gas cushion" will largely eliminate a major government-created advantage which is very unevenly distributed among gas companies.

A partial deregulation structure implies that those pipelines with the largest blocks of cheap regulated gas will have lower average resale rates and a greater ability to purchase new natural gas (i.e., an ability to pay relatively higher prices without seeing average retail rates exceed alternate fuel prices). In this way, partial deregulation imparts significant economic advantages to gas companies and consumers in some areas of the country and disadvantages to others for no reason other than government fiat and historic accident.

PGC does not accept the theory that the "cushion" is no longer meaningful because high priced gas contracts have totally offset it. First, although no one has accurately assessed all pipelines' cushions, it appears that not all pipelines have used up their cushions. Thus, some pipelines will have significant advantages in future years. Second, the observation that some pipelines have already offset their old gas cushions with expensive deregulated gas does not mean that the cushion can be forgotten. If lower deregulated gas prices result from a resolution to the contract problem or if petroleum prices increase significantly, the importance of the old gas cushion could quickly be reestablished to the advantage of some pipelines over others. That, in turn, would lay the foundation for a new cycle of excessive bidding on new supplies -- i.e., for a new contract problem -- parallel to the one from which we are now trying to extricate ourselves.

PGC submits that the Nation and the gas industry as a whole would be better served if these artificial differences are removed as soon as possible.

C. Equivalent or Cheaper Retail Prices

Deregulating the price of all natural gas will not raise the average retail gas price any higher than will partial deregulation of new gas only. Competition with alternate fuels at the retail level will establish the upper limit for retail prices regardless of whether wellhead prices are deregulated in whole or in part. That is, the average wellhead price will settle at whatever level is needed to sell the total volume of deliverable natural gas supplies at the retail level.

Consequently, the primary effect of restricting some gas wellhead prices at below the average market level is simply to produce above-average prices for the remaining, deregulated volumes of gas. In other words, in a setting of partial price controls, producers of deregulated gas and foreign gas exporters will get the principal economic advantage of the regulated cushion, not users. The exorbitant price of Section 107 gas under the NGPA amply demonstrates this fact. Large sums of capital have been diverted to drilling deregulated gas deeper than 15,000 feet rather than cheaper sources in shallower reservoirs, solely in order to capture the special economic benefits afforded by the NGPA's cushion of regulated gas.

In fact, the NGPA's complex mix of partial price regulation and phased deregulation is producing higher overall prices than would prevail in a totally free wellhead market. Deregulation of all supplies accompanied by a solution to the NGPA-created contract problem would produce lower retail gas prices than under the NGPA, in both the short and long-terms.

D. Lower Long-term Industrial Rates

Total decontrol of wellhead prices will likely hold down industrial rates in another way. This benefit will result because the danger of discriminatory rate schemes, such as incremental pricing, end-use rate schedules, marginal cost pricing and inclining block rates, will be substantially reduced if all natural gas is being sold at roughly equivalent wellhead prices.

Those types of discriminatory rate schemes would allocate a disproportionate share of relatively high cost supplies to industrial users on the basis of the misleading claims that industrials are the "cause" of high-cost gas purchases and that they are "marginal users" who should keep new supplies in line (i.e., "order the market") while other users burn regulated cheap gas at below average cost. By eliminating the major basis for discriminating on gas cost allocations, true cost-of-service ratemaking will be more easily and consistently implemented for the benefit of all consumers.

Although some have suggested that the dangers of discriminatory rates are lower today as a result of widespread concern about the Nation's poor economy and the risk of plant shutdowns, industrial users doubt this. Even now, in today's economic circumstances, such discriminatory theories are espoused by some States (e.g., California), by some so-called "consumer groups," and even by some distributors (e.g., Laclede). (See comments filed in the FERC's Notice of Inquiry, RM82-26). Moreover, industrials are concerned that these arguments will be still more widely made, in healthier economic times, if there remains a wide range of wellhead gas prices. Consequently, ending the root cause of the problem--i.e., artificial differences in wellhead prices--will help to produce greater long-term price stability for pipelines, distribution companies, and consumers. That greater assurance of consistent, fair treatment will help immeasurably to restore industrial users' confidence in the natural gas system.

E. Greater Stability for the Entire Gas Industry

Just as industrial users would benefit, more consistent implementation of true cost-of-service ratemaking and economically rational pricing of wellhead sales will also produce greater long-term stability for distributors, pipelines, producers and non-industrial consumers. Long-term gas prices will be easier to project because there will be no artificial price discontinuities between categories of gas; and regulatory gamesmanship, such as "category creep" (in which old gas is reclassified into higher price categories), should cease to be a problem. Moreover, even-handed implementation of cost-of-service ratemaking will produce the greatest likelihood of stable resale markets, including industrial markets, which are vital to the long-term health of the natural gas industry.

F. Similar Production Levels

It is sometimes argued that deregulating only new gas will enhance exploration and development of new supplies because prices for new supplies would be subsidized by controlled old gas prices. At first glance, this sounds like an attractive proposition, especially to those who suffered from curtailments in the 1970's. However, while it is obvious that deregulating only "new" gas will affect the pattern of production, exploration and development, it is less clear what the net effect will be on overall production levels, as compared to the production which would occur if all gas is deregulated.

It is likely that deregulating only "new" gas will simply result in a situation in which wellhead contracts signed in the first year or two following such partial deregulation will command a price premium which effectively locks-up the economic benefits of the old gas cushion. New contracts signed thereafter would contain lower prices which would not be materially above the expected long-term market clearing level. In fact, there is significant evidence that this pattern is occurring under the NGPA: prices in new Section 107 contracts have reportedly fallen substantially from their 1980-1981 levels, and contracts with extreme deregulation provisions are standing by to offset any remaining volume of old gas cushion in 1985. Thus, the NGPA's relatively larger drilling incentives for new gas may have already come to an end; and the NGPA's long-term effect on supplies may be minimal.

On the other hand, if all supplies were deregulated, one might expect temporarily accelerated development and production of old supplies, since that would be the cheapest way for producers to obtain the benefits of deregulation in the short-term. However, that would soon be followed by increased exploration for, and development of, new sources as producers saw that the old gas supplies would need to be replaced with new reserves. In addition, somewhat enhanced recovery of gas from old reserves would probably ensue from total deregulation, improving gas supply availability to some extent.

Comparing these alternatives, it is difficult to declare with any confidence that one yields greater supply availability than the other. The principal differences between the two alternatives might simply relate to the timing of reserve additions and production from particular sources of supply, not to total gas deliveries at any particular time. Thus, without more, arguments that decontrolling only new gas would increase supply more effectively than would complete decontrol are not persuasive.

Moreover, even if the implicit subsidies from an old gas cushion under partial deregulation increased near-term exploration for, and development of new gas, thereby enhancing supplies for a period, the longer term effect might simply be higher gas costs following exhaustion of the cushion. This could result if more rapid production of new sources during the period of old gas subsidies leaves the Nation with relatively more costly sources to develop, without the benefit of subsidies, thereafter.

V. CONCLUSION

On balance, complete deregulation of all wellhead prices for natural gas by a date certain, combined with a market-oriented resolution to the NGPA's contract problem, and prompt elimination of demand restraints, will produce the fairest and most economically efficient solution to the problems confronting the Nation's gas markets. The long-term health and stability of the natural gas industry and its customers, including industrial customers, will be improved by that action.

Any effort to retain controls on some or all categories of supplies will inevitably yield market distortions analogous to those experienced under the Natural Gas Act and the NGPA. Some of those distortions are predictable; others are not. Experience indicates, however, that the Nation will be hurt more by an extension of partial controls than by ending our unfortunate experience with wellhead price regulation as soon as possible.

The Process Gas Consumers Group appreciates this opportunity to present its views to this Committee. We will welcome the opportunity to work further with the Members and Staff of the Committee in addressing these vitally-important natural gas issues.

December 13, 1982

STATEMENT OF RICHARD C. PERRY, DIRECTOR, HYDROCARBONS SUPPLY PLANNING, UNION CARBIDE CORP., ON BEHALF OF THE PETROCHEMICAL ENERGY GROUP, ACCOMPANIED BY GORDON GOOCH OF BAKER & BOTTS

Mr. **PERRY**. Mr. Chairman, we certainly agree that NGPA has big problems and needs fixing. After analysis of the proposals, as major consumers, we had to conclude that these emergency proposals will not fix the problems, as we understand them, and in our testimony we outlined reasons for this.

As an example, the price freeze, we don't think will take care of the job, because as this chart illustrates, the problem is with shifting sources of the gas supply away from old, low-price gas and toward now and high-cost gas. Therefore, price fix per se will not solve that.

We also deal with take or pay and least cost solutions. It is a complex problem and we don't believe that one more regulation, however well the intention, will fix it. We hope that legislation will be dealt with comprehensively for a complex subject. As a consumer, we have far more reliance and greater stress on the marketplace solutions and less on one more regulation.

Thank you.

[The prepared statement of Mr. Perry follows:]

TESTIMONY OF RICHARD C. PERRY
ON BEHALF OF
THE PETROCHEMICAL ENERGY GROUP

Thank you Mr. Chairman. I am Richard C. Perry, Director, Hydrocarbons Supply Planning, Union Carbide Corporation. With me today is Gordon Gooch of Baker and Botts. Following my statement we will both be pleased to answer any questions. I was asked by the Petrochemical Energy Group (PEG), to present this testimony in response to the Committee's request for information on the current gas situation and comments on the legislation which has been introduced.

Introduction

Those who appear before this Committee to urge a freeze on producer prices or to compel the FERC to review the purchasing practices of the interstate pipelines as an emergency device to bring down gas prices are doomed to disappointment, even if they succeed totally with their legislation. Those who seek to outlaw take-or-pay clauses threaten to destroy gas markets and supplies in exchange for only temporary and only possible relief. I will explain why this is so, and I gratefully acknowledge the two primary sources of information, both recent Governmental reports. One is, "An Analysis of Post-NGPA Interstate Pipeline Wellhead Purchases; An Analysis of the Natural Gas Policy Act and Several Alternatives, Part III," DOE/EIA 0357, September, 1982, (herein EIA). The other is a report by the U.S. General Accounting Office requested by Senator Thomas F. Eagleton, et al., and released December 9, 1982, entitled, "Natural Gas Price Increases: A Preliminary Analysis," GAO/RCED-83-72 (herein GAO).

The Freeze

First, allow me to explain why freezing wellhead prices will not do what the advocates contend. Why? Because you can freeze the price and the average can still rise!

Please consider what has happened, according to the EIA. The average price of regulated gas went up only four percent in 1982 constant dollars in one year, mid-81 to mid-82. 1/ Regulated gas accounts for over 90% of the available supply. 2/

We have confirmed this assertion by looking at the regulated prices for natural gas as set forth in the Federal Register, and conclude that there is no rapid escalation of prices for over 90% of the gas supply in this country. 3/ (See the graphs showing prices at Attachment A.)

The EIA further found that the average price of high cost and deregulated gas at the wellhead went up 18%, even though the price is trending downward. 4/ This type of gas accounts for less than 10% of available supply. 5/

As we understand it, in unadjusted dollars the old gas actually went down in price by $.17, new gas went up by $.33, and high cost gas went up by $1.58. In percentages, old gas went down by 11%, new gas went up by 12%, and high cost gas went up by 27% on average. 6/

But, one might think, the average of all gas sales at the wellhead could not move up much, given the greater volume of regulated gas. However, the EIA found that the average price went up 17% in constant dollars, mid-81 to mid-82, 7/ because, quoting EIA, "The increase is due primarily to the shift of purchases from less to more expensive categories rather than to price increases within categories. There is, however, no evidence that companies have been converting old gas into new gas." 8/

The GAO report reaches a consistent conclusion. "The changes in proportionate quantities appear to account for about twice as much of the overall change as the price changes. Even after the 7% inflation rate between the two periods is considered, the changes in proportionate quantities appear to account for at least half the overall change." 9/

If EIA and GAO are correct in their analysis, the Congress could freeze the producer prices and the average could still continue to rise, if more and more expensive gas is taken in place of the cheaper gas.

In short, what some advocates of reimposition of more price controls in order to hold down the average price of gas have overlooked is that the price is only one factor. Another is the relative volumes of gas taken from the many NGPA categories.

Also overlooked is the fact that there are pipeline and distributor costs in the burner tip rate which also go up. 10/ In fact, under regulation, as volumes of gas sales decline, the pipelines and distributors are impelled to seek rate increases in order to recover their costs and their profits spread over the lower volume. 11/

Still further overlooked is that there are sources of gas to the pipelines that are not covered by this legislation. For example, imports from Canada and Mexico are priced at $4.94, 12/ imports from Algeria at over $7, 13/ and gas manufactured from or blended with liquid petroleum products at over $5. 14/

I am not finished yet. What about purchases from the pipeline-owned production? Some of the recent increases in wellhead prices are going to the pipelines, not to the producers, because of the recent Mid-La decision. 15/ As EIA puts it, "[Pipeline] companies with large owned reserves look forward to including them under NGPA provisions at higher prices than previously allowed." 16/

Finally, what about purchases from other pipelines? 17/

Thus, freezing the price of gas to the independent producer does not assure that average prices will not continue to rise, whether driven by American, Canadian, Mexican, Algerian or synthetic gas manufactured from petroleum.

Take-or-Pay; Regulatory Approaches

Once it is realized that it is not the price levels of gas that are the primary cause of the average wellhead price of gas rising, but rather it is the volume of the various categories of natural gas that is the primary cause of the problem, the questions then become, why is there a problem on the volumes taken and whether outlawing take-or-pay clauses is a solution that really solves more problems than it creates?

Both EIA and GAO hypothesize that part of the answer as to why there is a shift to more expensive gas may be that the older, cheaper gas has been depleted. 18/ If so, outlawing contractual provisions cannot be expected to yield much results.

But if the shift to more expensive gas is a matter of choice on the part of the pipelines, what are the possible reasons? GAO answers this question:

> There are several possible reasons why pipelines--when they expect to need less gas than they could purchase under existing contracts--may choose to forego relatively inexpensive gas and, instead, purchase relatively expensive gas. First, as a general rule, the more expensive gas is likely to be covered by contracts with higher "take" obligations. This occurs because take-or-pay clauses became more prevalent during the last decade or so, at the same time that maximum lawful prices were being increased.
>
> Second, pipelines may prefer to buy gas from their own affiliated producers or production subsidiaries, rather than from unaffiliated producers. This could cause pipelines to buy relatively expensive gas because pipeline involvement in gas production has increased in recent years, at the same time that maximum lawful prices were being increased. Third, pipelines may be willing to pay higher prices to develop or retain the good will of producers on whom they may depend in various producing regions.
>
> Finally, pipelines' purchases may be influenced by the nature of Federal regulation. Pipeline tariff rates are estab-

lished at least every 3 years based on a cost-of-service review. One aspect of such a review is a determination of the cost of gas purchased by the pipeline for resale. Recognizing that purchased gas costs would likely change more frequently than every 3 years, pipelines were allowed, starting in 1972, to adjust their rates in the intervening period. A pipeline's request to change its base tariff rates to reflect purchased gas costs is known as a purchased gas adjustment filing. Most interstate pipelines file an application every 6 months, while the remainder file annually. These filings are subject to FERC review and approval.

In the situation where a pipeline is contractually obligated to pay for more gas than its needs, if the pipeline pays for and receives gas from a producer, it can generally recover its costs through a purchased-gas adjustment filing every 6 months according to FERC officials. However, if a pipeline pays for but does not receive the gas, it cannot promptly recover such "pre-payments." Only after it receives the gas can it recover these "pre-payments" through a purchased-gas adjustment filing.

In the meantime, the pipeline can add the "pre-payments" to a specified account in its rate base and earn a rate of return on them. Therefore, to maintain cash flow, a pipeline may prefer to buy more expensive gas and recover its costs semi-annually, but incur any "pre-payments" on less expensive gas and recover these costs later. To the extent that "take-or-pay" and other contract clauses influence a pipeline to buy more expensive gas and forego less expensive gas, such clauses will contribute to an increase in the pipeline's average gas costs. 19/

Let us review the possible reasons listed by GAO.

First, because there are take-or-pay clauses in the contracts for more expensive gas. 20/ Take-or-pay, as we understand it, is simply a prepayment for gas to be taken in the future. We further understand that the consumer of natural gas does not pay the take-or-pay prepayment. We understand that the take-or-pay payment itself is strictly a matter between the pipeline and the producer. All the consumer is at risk for is the carrying charges on the prepayment, and that only if approved by the FERC in an interstate pipeline's rate case. 21/

If any part of the answer lies in this possibility, that is, the payment of the prepayment itself under take-or-pay clauses is the problem, then we must note that it is a matter which involves the producing sector of the industry and the pipeline sector of the industry, because we users do not pay the take-or-pay payment. The equities lie between these two sectors, and we believe that it is far better for the two contracting parties to sort out the equities between them than for the Congress to decide who gets the use of this money. The consequences of a congressional decision to withhold capital or cash flow from those who explore for and develop natural gas cannot be ignored.

In times of gas surplus, it may not be fashionable to worry about gas supply, but if the Congress decides to allow the pipelines to withhold the cash flow from producers currently and to outlaw any contractual assurance that some cash flow can be counted on if producers offer new gas for sale in the future, the supply implications are indeed serious. If the Congress freezes prices, cuts off assured cash flow, and proscribes takes from new production, neither the banks nor the producers are likely to fund exploration and development. 22/

Furthermore, it appears to us that Senator Chafee's analysis of the result of outlawing take-or-pay clauses is accurate. He states: "This does not mean that the pipelines will simply walk away from the suppliers. It does mean that we would be giving the pipelines the power to renegotiate their contracts with the producers in much more realistic price terms." 23/ We might express the result somewhat differently: The producer is placed at the mercy of the pipeline, who can shut in or cut back takes until other contract and price concessions can be obtained. This radical change in the bargaining positions which would be effected by this legislation perhaps is re-regulation at its worst.

Second, according to the GAO, pipelines may prefer to buy gas from their own affiliated producers or production subsidiaries, rather than from unaffiliated producers. 24/ If any part of the answer lies in this possibility, then outlawing take-or-pay on independent producer contracts will only facilitate this conduct.

Third, pipelines may be willing to pay higher prices "to develop or retain the good will of certain producers on whom they may depend in various producing regions." 25/ Again, if any part of the answer lies in this possibility, then outlawing take-or-pay does not appear to be helpful.

Fourth, according to GAO, pipelines are encouraged to buy expensive gas which they can pass on to their customers on a current basis, whereas there is delay and risk to the recovery of carrying charges in rate cases if the expensive gas is shut in.

If any part of the answer lies in the fourth and final question - that the way the FERC regulates take-or-pay is the problem, then there is obviously a regulatory solution. To expand on this point, if any part of the answer lies in a fear by the pipelines that the FERC will deny or delay the collection of the carrying charges on gas prepayments, then why not allow carrying charges to be included in the PGA filings? It seems to us that the average cost of gas would go down to current consumers if take-or-pay carrying charges were flowed through on the high cost gas. *\/

---

*\/ We can understand the argument that the pipelines might prefer to run their high cost gas because they can recover the cost of the high cost gas presently in their PGA's while if they shut in the high cost gas they have a higher prepayment to make to the producer and the risk that the carrying charge will not be passed on to their customers in their next rate case. Let me illustrate the principle. Assume that a pipeline has a choice of taking gas for $10 or of taking gas for $2, but not both, and that both have 100% take-or-pay and that the pipeline's carrying cost for rate purposes is 20%. Under this hypothesis, the pipeline must shut in one and take the other. Which does the pipeline choose? If the pipeline takes the $2 gas, then the pipeline must advance $10 in cash and try to recover $2 in carrying charges from its customers in a rate case, spread over all sales volumes.

If, however, the pipeline takes the $10 gas, that cost is flowed through the PGA to the consumer without delay, the pipeline only has to advance $2 in cash and only has to try to recover $.40 from the customers in a rate case, spread over all sales volumes.

It may be in the customers' best interests that the customers pay $2 for the cheaper gas and a fraction of the $2 carrying charge rather than $10 and a fraction of the $.40 carrying charge.

In addition to the above GAO, in its conclusions, lists other factors as well:

> Numerous factors have contributed to natural gas price increases before and since enactment of the NGPA. End-user rates for natural gas depend on the diverse factors affecting how gas is priced to pipelines, to distributors, and to end-users.
>
> Prices paid by pipelines are based on purchases of both domestic and imported gas. Prices for domestic gas depend on both the quantity of gas in each category and the price for each category; these quantities and prices, in turn, are influenced by many factors, including (1) the NGPA's escalation provisions, (2) incentive prices for high-cost gas, (3) depletion of old fields, (4) recategorization of gas, (5) "take-or-pay" and other clauses in producer-pipeline contracts, (6) Federal regulations, and (7) other factors.
>
> Prices paid by distributors depend, in part, on increases in pipeline operating expenses and rates of return and the loss of direct sales to industrial and electric utility customers. Prices paid by end-users depend, in part, on the allocation of cost increases between residential, industrial, and other users. 26/

Which of the above possibilities explains all or any part of the current situation? Or, are there other possibilities which we have overlooked? Lack of an answer to those questions argues against a precipitous decision to outlaw take-or-pay clauses. Furthermore, take-or-pay, or its equivalent the minimum bill clauses for imports, for pipeline-to-pipeline sales, or on LNG or SNG is not addressed in the legislation.

"Least Cost"

Finally, I turn to the suggestion that the FERC be compelled to review the purchasing practices of the interstate pipelines in order to assure that the "least cost" mix of producer contracts is being run. A few comments are in order.

First, the FERC, rightly or wrongly, already claims the jurisdiction to review the purchasing practices of the interstate pipelines, 27/ so the suggestion is not new.

Second, there are more sources of gas than sales by independent producers to consider, such as imports, the pipeline's own production, LNG and SNG, and pipeline purchases from other pipelines. 28/

Third, how many years will it take to examine the purchasing practices of the 129 29/ interstate pipelines or even of the thirty or so class "A" pipelines 30/ on a contract-by-contract basis through FERC hearings and appeals? Particularly when many of the pipelines file their projected purchasing patterns every six months? Is there any immediate hope for a quick fix?

Conclusion

Finally, candor compels me to say that the Congress will continually be called upon to make adjustments in the NGPA and in the NGA as market and other conditions change, and each and every adjustment will breed another inequity which, in time, will also have to be adjusted. It would be a far, far better course of action for all concerned to terminate federal price and allocation controls over the wellhead sales of natural gas as soon as possible.

PEG has testified before this Committee and elsewhere 31/ on the various problems in gas markets resulting from the NGPA. We share the serious concern about gas markets which has motivated the authors of proposed natural gas legislation including those bills introduced in this special session. But the remedy should address the causes of gas market problems, not the symptoms generated by these causes.

The number one problem is, and remains, the "cushion" of price controlled gas. This cushion allows some pipelines to bid the present and future prices of gas to noncompetitive levels. Freeze or even rollback legislation does not address this problem. The pipelines with a cushion will continue to have a competitive advantage. As to pipelines without a cushion, their consumers are and will be disadvantaged, for the reasons given in our previous testimony. As EIA more delicately puts it, "Companies with large quantities of controlled gas supplies may be very well placed to bid in later years." 32/

Work is going on to develop legislative proposals that would address, in a comprehensive way, the problems plaguing natural gas markets, problems which will become more serious over time. We believe such a solution promises far greater benefits for gas consumers, including industrial consumers, than any of the quick fix proposals, all of which are likely to make the longer term problems worse.

Specifically, PEG continues to recommend that the NGPA should be amended to accomplish the deregulation of all wellhead sales, not only as to price controls, but also as to federal controls which allocate gas to a particular pipeline or to a particular market, such as abandonment requirements, rights of first refusal, minimum contract duration, and preferential access to Outer Continental Shelf gas. It is essential that total decontrol occurs on a single date certain, not piecemeal on two or more dates. Thus, a phased decontrol schedule, even with earlier deregulation in whole or in part of new wells, should reach a single target date on which controls terminate; one or more categories of gas should not have a different target date. The objective should be to bring the average price of gas at the wellhead to a market clearing level and to eliminate all "cushions" caused by price ceiling controls for all gas on the single target date for decontrol.

If these objectives are met by legislation, then demand controls, such as incremental pricing and Fuel Use Act restrictions, should also be eliminated.

Thank you for allowing us to address these important issues.

FOOTNOTES

1/ Energy Information Administration, U.S. Department of Energy, An Analysis of Post NGPA Interstate Pipeline Wellhead Purchases, DOE/EIA-0357, at 37 (1982). [Hereinafter cited as EIA].

2/ Id. at 8.

3/ See, Prescribed Maximum Lawful Prices Under the Natural Gas Policy Act of 1978, 47 Fed. Reg. 47808 (1982) (codified at 18 C.F.R. 271.101(a)). For prices from December 1978 to present see also, II FERC (CCH) ¶ 24,111 (1982).

4/ EIA, supra note 1, derived from Table 1 at 6.

5/ Id. at 8.

6/ Energy Information Administration, U.S. Department of Energy, Table ES1, "Projected Natural Gas Wellhead Purchase Volumes and Prices for Major Interstate Pipeline Companies 1981-1982" (Working Paper unpublished).

7/ EIA, supra note 1, at 37.

8/ Id.

9/ General Accounting Office, Natural Gas Prices: A Preliminary Analysis, GAO/RCED-83-76 at 11 (1982). [Hereinafter cited as GAO].

10/ Id. at 24.

11/ Id. at 24-25.

12/ Federal Energy Regulatory Commission, Annual Report 1981, FERC 0099 at 8-9 (September 15, 1982).

13/ Trunkline LNG Company, Order Accepting for Filing and Suspending Proposed Tariff Sheets Subject to Conditions and Establishing Procedures, Docket No. RP81-85 (July 31, 1981).

14/ Transcontinental Gas Pipeline Corporation, Application for Certificate of Public Convenience and Necessity, Docket No. CP80-485 (filed August 7, 1980, decision pending before Administrative Law Judge); Columbia Gas Transmission Corporation, Notice of Application, Docket No. CP82-427 (August 11, 1982).

15/ *Mid-Louisiana Gas Co. et al. v. FERC*, 664 F2d 530 (5th Cir. 1981), *cert granted*, 51 U.S.L.W. 1051 (U.S. October 4, 1982) (No. 82-19). This decision allows an interstate pipeline to price its own gas production from pre-October 1969 leases and pre-1973 wells at NGPA ceiling prices rather than at the previously applicable cost of service basis; *see* El Paso Natural Gas Company, Order Granting in Part and Denying in Part Rehearing Applications and Convening A Technical Conference on Certain Unresolved Issues, Docket No. TA82-2-33-001 (September 30, 1982). *See also*, EIA, *supra* note 1, at 152.

16/ EIA, *supra* note 1, at 39.

17/ Energy Information Administration Office of Oil and Gas, U.S. Department of Energy, *Gas Supplies of Interstate Natural Gas Pipeline Companies--1980*, DOE/EIA-0167(80), Preface, and at 85 *et seq*. (1981); EIA, *supra* note 1, at 152.

18/ EIA, *supra* note 1, at 37; GAO, *supra* note 9, at 11.

19/ GAO, *supra* note 9, at 19-20.

20/ *But see*, Energy Information Administration, Office of Oil and Gas, U.S. Department of Energy, *Natural Gas Producer/Purchaser Contracts and Their Potential Impacts on the Natural Gas Market*, DOE/EIA-0330, at 41 (1982), where substantially the same take percentages were also found in contracts for old, price controlled gas.

21/ See explanation in GAO *supra* note 9, at 20. *See, e.g.*, Limitations on Provisions in Rate Schedules Relating to Makeup Period for Taking Prepaid Gas, 18 C.F.R. § 154.103 (1982); Uniform System of Accounts for Natural Gas Companies, 18 C.F.R. Part 201, § 165 (1982); Changes in a Tariff, Executed Service Agreement or Part Thereof, 18 C.F.R. § 154.63(f), Schedule E-1 and E-2 (1982).

22/ *Cf*. comments of Interstate Natural Gas Association of America at 28 in response to Notice of Inquiry on the Impact of the NGPA on Current and Projected Natural Gas Markets, Docket No. RM82-26-000.

23/ 128 Cong. Rec. S14207-14209 (daily ed. December 8, 1982) (Statement of Sen. Chafee).

24/ *See, e.g.*, Notice of Intervention, Petition for Suspension of Tariff and Request for a Hearing of the People of the State of California and the Public Utilities Commission of the State of California, In the Matter of El Paso Natural Gas Company, Docket No. TA83-1-33 (September 17, 1982).

25/ GAO, supra note 9, at 19.

26/ Id. at 26.

27/ Tennessee Gas Pipeline Company, Order Denying Rehearing, Docket Nos. TA82-2-9, RP81-54, RP82-12, TA82-1-9-001 (October 1, 1982).

28/ See summary of volumes obtained from various sources in Energy Information Administration, Office of Oil and Gas, U.S. Department of Energy, Statistics of Interstate Natural Gas Pipeline Companies--1980, DOE/EIA-0145(80), at 29-31 (1981); EIA, supra note 1, at 152.

29/ GAO, supra note 9, at i.

30/ Energy Information Administration, supra note 28, at iii-iv.

31/ Most recently, Testimony of John Johnson before the Subcommittee on Fossil and Synthetic Fuels, Committee on Energy and Commerce, U.S. House of Representatives (July 30, 1982); Testimony of Gordon Gooch before the Committee on Energy and Natural Resources, U.S. Senate (March 23, 1982); Testimony of Robert L. Mitchell before the Committee on Energy and Natural Resources, U.S. Senate (November 6, 1981); Testimony of Leonard A. Cohn before the Subcommittee on Energy Regulation, Committee on Energy and Natural Resources, U.S. Senate (April 24, 1981).

32/ EIA, supra note 1, at 38.

Maximum Lawful Price Per MMBtu for Deliveries
(Actual Oct. 1980 to Oct. 1982)
In Current Dollars

Composited by
Baker Botts
Washington

November, 1982

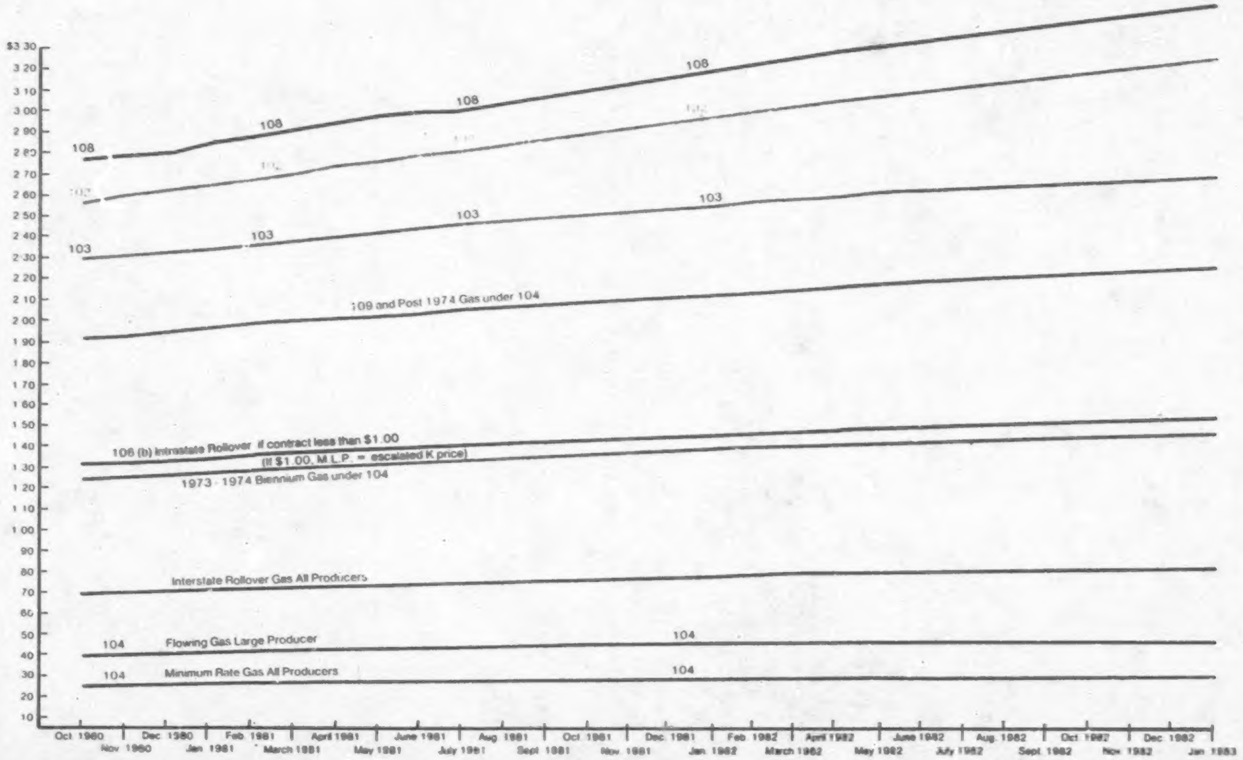


Table 19. Pipeline Contract Patterns[a]

Pipeline Name	Total Gas		Old Gas[b]		New Gas[c]		High Cost Gas[d]	
	Volume (Billion Cubic Feet)	Average Price (Dollars per Thousand Cubic Feet)	Percent of Total Volume	Average Price (Dollars per Thousand Cubic Feet)	Percent of Total Volume	Average Price (Dollars per Thousand Cubic Feet)	Percent of Total Volume	Average Price (Dollars per Thousand Cubic Feet)
Southern	446	2.67	56	1.19	30	2.92	14	8.04[f]
Transco	843	2.76	43	1.49	47	2.98	10	6.09
United	670	2.35	34	1.03	56	2.71	9	5.03
Consolidated	102	1.99	29	1.45	71	2.20	(e)	(e)
Trunkline	373	2.53	68	1.60	23	2.98	9	7.00
CIG	292	2.65	46	0.97	40	3.12	13	7.06
Columbia	678	2.74	58	1.37	33	2.89	9	7.76
Northwest	135	1.89	62	1.26	37	2.92	(e)	3.63
Michigan/ Wisconsin	340	1.86	70	1.34	26	2.90	3	4.96
El Paso	1,015	1.92	59	1.13	37	2.96	4	6.20
Transwestern	279	1.96	48	0.78	48	2.78	4	5.81
Florida Gas	132	1.88	66	1.02	28	2.97	6	3.84
Texas Gas Trans.	438	2.17	70	1.19	22	2.89	8	8.81
Natural Gas P. of A.	863	1.80	78	1.37	22	3.02	(e)	3.73
Tennessee	1,073	2.06	71	1.47	27	2.99	2	8.23
Kansas/ Nebraska	75	1.62	74	0.98	21	2.83	5	6.39
Northern Natural	693	1.36	68	0.91	29	2.79	3	3.39
Panhandle Eastern	320	1.64	64	0.91	34	2.86	2	6.00
Cities Service	303	1.98	44	0.53	43	2.83	13	4.02
Texas Eastern	309	1.30	79	0.86	20	2.96	(e)	3.92

[a] See Appendix B for development of this data.
[b] Gas covered by NGPA Sections 104 and 106.
[c] Gas covered by NGPA Sections 102, 103, 108, and 109.
[d] Gas covered by NGPA Section 107.
[e] 0 or near 0.
(Percentages may not add to 100 due to rounding).

Source: The Current State of the Natural Gas Market
An Analysis of the Natural Gas Policy Act
and Several Alternatives, Part 1 (EIA/December 1981)

Relative Percentage of Volume and Price for First Pipeline Listed on Table 19

Figure 1

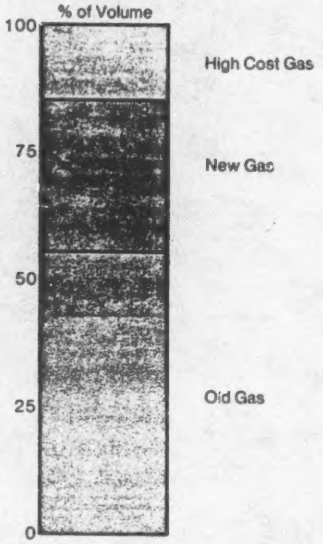
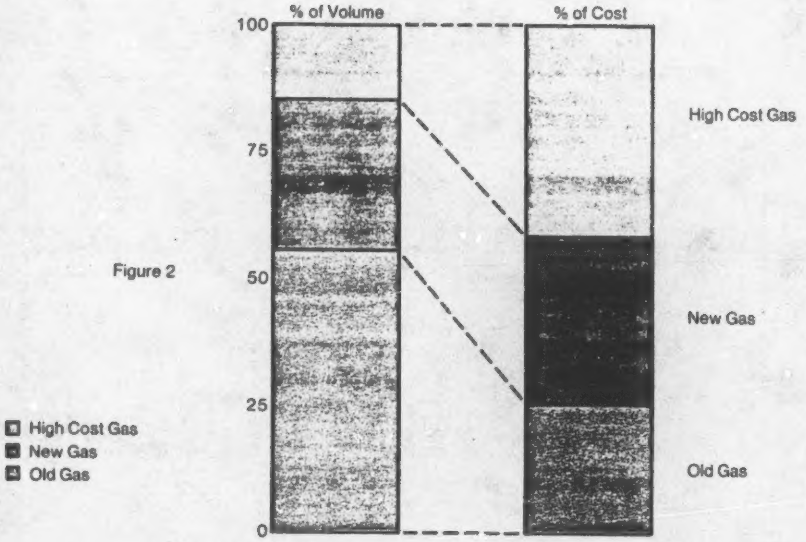
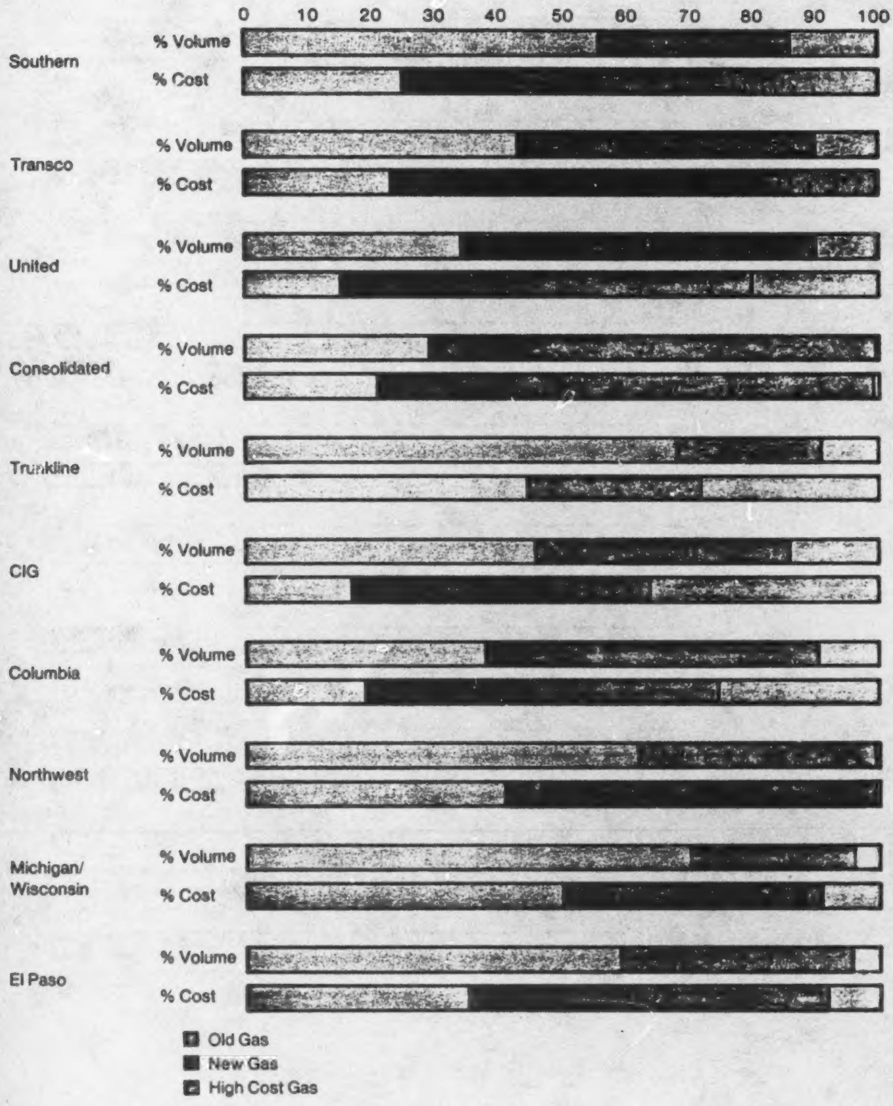


Figure 2



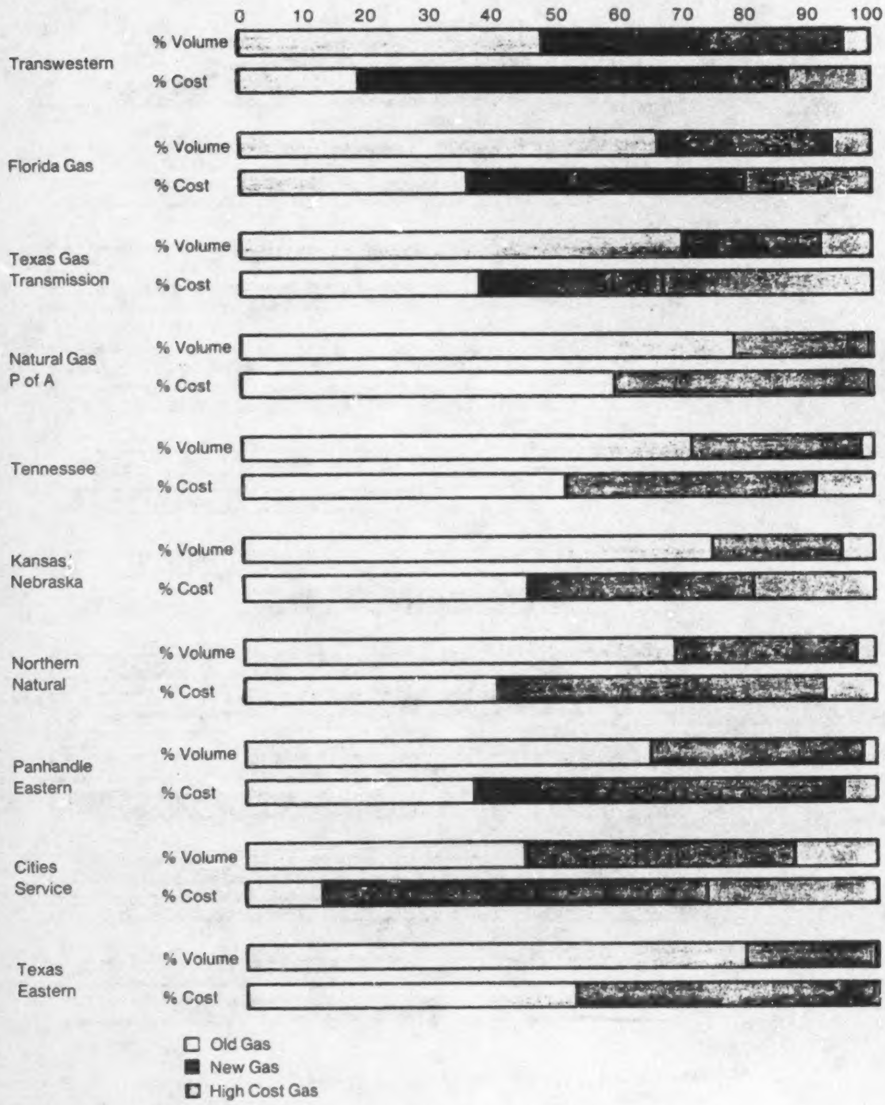
SOURCE: Table 19, An Analysis of the Natural Gas Policy Act and Several Alternatives (EIA, 1981)

**Relative Percentage of Volume and Price
Pipeline Contract Patterns**



SOURCE: Table 19. An Analysis of the Natural Gas
Policy Act and Several Alternatives (EIA, 1981)

Relative Percentage of Volume and Price Pipeline Contract Patterns (Cont'd)



SOURCE: Table 19, An Analysis of the Natural Gas Policy Act and Several Alternatives (EIA, 1981)

Senator **Warner**. Thank you. I appreciate your indulgence. I will now recess the hearing subject to the call of the chairman, who is now seeking an extension of time for the committee to sit. I and others have urged that the hearing continue because of the vital importance of the subject matter.

I thank you for your participation. I hope this hearing has begun to explore, within the very limited time available, the problems with the NGPA.

[Whereupon, the hearing was recessed, to reconvene at the call of the Chair.]

The **Chairman** [Senator Mclure presiding]. The committee will come to order. We do have permission to sit. We are not going to have to become as informal as I was afraid we would have to be. It was my intention that we would if it had been necessary to adjourn the hearing after having made all of your prepared statements a part of the record, to then have an informal discussion, necessarily off the record if we did not have permission to sit.

That has been rendered moot. We have unanimous consent and therefore we can proceed on the record. I am very grateful for that opportunity.

I believe that the prepared statements of each of the witnesses has been already made a part of the record and will appear in full in the record. I understand that each of you had the opportunity to make a very brief summary of your statement. It was necessarily extremely brief. For that reason, I would ask if you have brief additional statements you would like to make at this time, I will give you that opportunity at this time to do that.

Let me just start at the left end of the table and I am not inviting you to restate everything you have already said, but I suspect there are some brief additional remarks you would like to make.

Mr. **Brandon**. Thank you, Mr. Chairman. I did refer earlier to two studies we have done, one indicating the consumer impact of the PGA filings this fall and the second, the survey we did nationally of potential facility disconnections this winter for people who cannot afford to pay their bills. I would ask whether they could be made a part of my statement.

The **Chairman**. Both of those documents have been made a part of the record.

Mr. **Brandon**. Let me just finish summarizing. The point I did not get to in my statement was looking at what the solutions might be that we believe are necessary to address the problem, that I outlined very briefly, that are in my written statement.

In that regard, we think that there needs to be comprehensive legislation to address several of the problems I talked about, just briefly restating them. There needs to be an elimination of the onerous take-or-pay and indefinite price escalation provisions that certainly exist in many contracts.

We also believe that there needs to be clarification of section 601 authority at FERC that would allow the Commission to look more carefully at the prudence standard for these contracts to qualify for the purchase gas passthroughs.

Third, we think it needs to be stated by Congress in legislation that it is not the Congress view that FERC should move in any way to administratively decontrol old gas prices as has been suggested by the Commission in the past.

Fourth, we believe there should be a limit on section 107 prices, either an absolute limit or a limit that is based on the prudence standard and an elimination of the rolled-in pricing provisions that FERC allows.

Finally, we believe it is essential that there be a freeze in prices and we do see the rate of escalation in the present ceilings. As was mentioned earlier, the price ceilings have become floors. We believe there has to be, to provide true relief to the consumers, a rationing down of those prices. And we are very concerned that those ceilings be maintained beyond 1985.

We feel whatever happens with the contracts, given the litigious nature of the gas industry, we expect several years of court battles and we believe that there needs to be adequate price protection during the period while the contract problem is solved and solved sufficiently so that signals can be given by consumers back to the producers in terms of what they can afford to pay in the natural gas pricing area.

The CHAIRMAN. Thank you.

Mr. SCHACHMAN. Thank you, Mr. Chairman. One, we support the timeframe of NGPA in the general outlines. We also support the concepts that have been discussed today, that there are problems with NGPA and they must be corrected. We believe, however, and have a great concern that anything done in this session of Congress would not provide relief at the affirmative or to the consumer this winter.

We have concern that once something has been done quickly with thought in mind, was completed that there would not be the necessary impetus to actually get down to the core of the problem and solve that early in 1983. For that reason at this time, what we would urge the committee to do is to increase the amount of low energy assistance available immediately. We believe that would provide the type of relief that has been discussed this morning for the consumers in question.

We do have great concerns about the definite price escalators, including those contained in NGPA. They have become floors and not ceilings. I found that ironic when you have people talking about the free marketplace and how NGPA is prohibiting it from working and that there is nothing in NGPA that prohibits producers and pipelines to renegotiate down below those prices. We have yet to see that and the producing companies certainly have not seen that.

We think there has to be a place in take-or-pay contracts so that there is flexibility as there would be in a free market, which is not currently available. We think that if the free market is to work at the wellhead, the market-out conditions must be seriously considered, so that when prices change at the distributor level, that is the fuels we are competing with, that that can be reflected at the real marketplace, the wellhead.

We also believe that there must be something put into section 601C so that there is a prudence test. It is very difficult as a distributor to defend PGA's at the State level when you are, one, not a party to the contract, which you are defending; and, two, have limited or no access to those contracts. I am sure the chairman would not want to be in the position of defending a contract somewhere which he was not a party to, nor have the document in front of him to defend.

So there must be some access to those contracts. As well we think that the comments this morning concerning the rate returns of the pipelines, regardless of the marketplace and how much gas there is sold, we think it is another issue that must be taken into account.

So in summary, with respect to the time limits that you have, sir, we would suggest that our position would be that while we definitely support the consensus and the concern, and I believe AGD has demonstrated that over the years, we believe the most appropriate answer at this time is to increase energy assistance and that will be the relief provided, the only relief that may be provided at the burner this year.

The CHAIRMAN. Mr. Cooper.

Mr. COOPER. Mr. Chairman, I agree with Mr. Schachman as to the low income energy assistance program. We have been supporting that. As to the substance of this problem, that is now before the industry, we believe it is an extremely complex thing that your committee must go into in great depth. We would like to participate in that process in any way we can and see a comprehensive approach taken to the whole, to all of the issues and all of the solutions.

We believe that the contract problem is a very, the one about the price redetermination, take-or-pay, that is a very difficult problem and just how that is worked out, we have a recommendation made as to how it may be, but it is something that has to be considered at great length.

We believe also that the ceiling prices in the NGPA are one of the major problems that are causing things to go up and that those must be revised for as long as they are in effect.

We think too that the matter of the relations between the pipelines and the distributors must be taken into account and we are particularly anxious to see that the pipeline rates and rate designs be so altered that the market can operate in a free fashion so that the signals, marked signals of the distribution companies, their unwillingness to take gas as prices go up and things like that may be freely reflected back to the field.

Finally, we think the matters of decontrol must be very seriously considered. We are in favor of decontrolling new, new reservoirs to broaden the market, but we are opposed to the decontrol of old gas, the old cushion gas. Our feeling there primarily is twofold. One, we don't see at the moment how that can possibly work without increasing the cost of gas and depreciating what you can pay for new gas.

We think the main thing is to have prices for new gas free and to be reflecting what it costs to get that gas. So those are our basic positions. We would like to go into them in depth with your committee.

Thank you very much.

The CHAIRMAN. Thank you. Mr. Elam.

Mr. ELAM. Thank you, Mr. Chairman. We have filed a 28- page statement with the committee and I did my best to squeeze it down to about 1 minute earlier. If I may I would like to make about three observations that have occurred to me outside of the framework of our written statement.

First, I need to tell you that I work for a textile company and in relative terms in our markets, we are large, but in absolute terms we are small. We have sales of about $700 million a year. And in thinking about the discussion this morning, it occurs to me that the discussion has been too limited in terms of the market that we are talking about. We are talking about a worldwide energy market. We are not talking about the domestic market in the United States for natural gas. I don't think you can view it that way.

Fuels compete with one another and what concerns me and the group I represent, the Process Gas Consumers, is that we use natural gas in a way where there is no substitutability. We use it in our industrial processes and we cannot switch to oil or coal or other fuels. So when other people switch we are left with those fixed costs, because there is nobody else to pay them but we industrials.

Second, I am worried about the effect on small business. I told you that my company is relatively small in absolute terms. Government regulation falls heavily upon everyone and the dollars are big for big companies, but it makes headlines when a big company goes out of business. There are a lot of small companies that are forced out by Government regulations that you never hear about. They just fade away.

We think a lot of that is going on now and more is going to go on if Government continues to control these markets.

Finally, as I listened to the discussion, it occurs to me that we have lost sight of how buyers and sellers operate in a free market. Even in a buyers' market, sellers are not defenseless and even in a sellers' market buyers are not defenseless. Sellers need buyers and buyers need sellers. We need each other.

In the textile business, a deal is not a good deal unless it is a good deal for both parties, the seller and the buyer. If you will open up these markets and free them, we people who depend on natural gas are not going to be helpless before the producers or the interstate pipelines or the distribution companies; we will have something to say about what prices are; and the market will work.

I don't see how you can keep part of it under control and call it a free market or depend on free market forces to operate. So we have confidence in the free market and we want you to bring about a free market, once again, so we can operate in it.

The CHAIRMAN. I think the dilemma for some of us is that once Government becomes involved in the regulatory process, people take actions based upon that regulation; and then how do we equitably shift from that position to the free market when people are dependent upon that structure and are adversely affected by the shift?

For myself, I have no doubt that the market is the best regulator in the longrun. But there are some people who are very severely affected by the changes that take place in the short run and I think that is one of the things we see here right now.

Mr. ELAM. We think we have given you a way out. We suggest that you let each party have an opt-out procedure, which will encourage and facilitate renegotiation. We would like to keep the framework of those renegotiations as free as possible.

The CHAIRMAN. I understand that. There are others who will argue, and always have before us, that the consumer at the end of the distribution pipeline may be somewhat different in his ability to freely participate in the market and the larger consumers have different options. I think that we have to recognize that we can talk about substitutability but for many people it is not very easy for them in their home heating to switch from natural gas to coal. It would not be any easier for them than it is to do it in your process. They are concerned and we are concerned about that fact as well.

Mr. ELAM. Of course, the prices we pay, if we can do so, are reflected in the prices of our goods. Corduroy and denim will keep people warm as well as natural gas, Senator.

The CHAIRMAN. Mr. Perry.

Mr. PERRY. Thank you, Mr. Chairman. I indicated earlier that our full statement contains several reasons why we think the currently proposed legislative amendments will not necessarily do the job of fixing up the current problems. We covered these under three subject areas. One, the price freeze aspects; two, the take-or-pay considerations; and, third, the least cost approach.

As far as the price freeze is concerned, as this chart indicates, part of the problem anyway is not solely with price ceilings but with the shift in gas sources from old gas to new or higher priced sources and there are several possible reasons why this might be the case.

I think both EIA and GAO have picked out several of these possibilities. One is that there is an exhaustion of old gas and that it just is not there to use anymore. And this may be part of the answer, but there are certainly several others.

If the shift from old gas to newer gas is a matter of choice on the part of the pipelines, and there are several possible reasons why that might be the case, and take-or-pay considerations are one of those, this is really a contractual matter between the producer and the pipeline and as has been mentioned earlier, it really has considerable implications as to the capital available for the drilling of wells and the producing. So we feel that that consideration is left much better to the private sector, to the negotiations that are now going on in many instances between the producers and the pipelines, rather than legislative address to take or pay per se.

There are several other possible reasons, however, of why pipelines might shift their gas sources. One is that they might prefer to buy gas from their own affiliated producers rather than from arm's length suppliers. Another possibility is that pipelines may be encouraged by expensive gas, which they can pass onto their customers on a current basis, that is without the delay of risk inherent in the carrying charges if the rate cases are undertaken.

There are several possibilities here and they all suggest that neither price ceilings nor take-or-pay address per se will necessarily solve that problem. It is a very complicated thing and we really feel it warrants more comprehensive address, which we hope will be the case later on rather than seeking a quick fix that will not necessarily solve the real problems.

The **Chairman**. Thank you very much. One of the questions raised this morning, and I don't think we have an answer, I think we received different comments from different people, all equally sure of their answer, and that is how far we can go with respect to modification of contracts and the means by which we will accomplish it if we desire to do so. When I say we, I am talking about the legislative process.

Set aside a moment, if I may, my attachment to the Constitution as I understand it to have been written and accept the Constitution the way the courts have said it was written and if you look at it from that standpoint, the courts are pretty likely to uphold from the constitutional concept standpoint a legislative effort to abrogate the terms of the contract. I think whether I like it or not, whether it is good law or good theory, I think it is fact and I think there is consensus on that point. But there seems to be no consensus with respect to the second point, and that is unless we statutorily fix what is done and set up objective criteria and determine that somebody else look at those criteria and determine what action should be taken, how do you evade due process?

Due process requirements perhaps get us to the point, if we recognize them they will not get there in time to help people this winter. That is a concern that I have, even though Senator Danforth said this morning that certainly the ingenuity of Congress was sufficient to come up with an answer. I have been around this ingenious place for a long time and the courts still seem to have a little difficulty in getting around due process requirements.

I wonder, first, if you might comment with respect to that and then I would ask for other comments as well.

Mr. **Brandon**. Mr. Chairman, first of all, I would agree with you that constitutionally, I think Congress can do something. I am also concerned about the notion that renegotiation can take place in the absence of any kind of legislative solution.

The **Chairman**. I did not mean to indicate that renegotiation cannot take place. I mean it can.

Mr. **Brandon**. No; I am saying that I think without a change in the accountability that pipelines must have over the standards on what would be acceptable in the way of a contract for getting the purchase gas adjustment, I think that there is little incentive now. In fact, in many cases pipelines with their own production have incentives to bid higher prices.

The **Chairman**. If, as a matter of fact, we addressed the question of accountability, is that not something that will take a lot longer than just the next 30 to 60 days?

Mr. **Brandon**. I think that is true. Although I would say if something could be done immediately, and I would share your view that it will not be, that the purchase gas adjustments that are in place for this winter are price increases and they are the bulk of the price increases being transmitted to consumers now. They could come down, because in effect new purchase gas adjustment rates would have to be filed by the pipelines and their commensurate reduction——

The Chairman. If you can do that and do it quickly without due process questions, we would have to simply abrogate take-or-pay provisions. That would have to be almost a blanket provision in the statute. Would it not?

Mr. Brandon. I think that is probably true.

The Chairman. If that is true, we then certainly would find that there are a variety of situations througout the country and throughout the industry in which that would have an uneven impact on different producers, different distributors and different consumers. Is that not correct?

Mr. Brandon. I believe that a comprehensive solution is necessary and I would share your views with that.

The Chairman. I am really groping with this question. I recognize the dilemma being presented to us by people who say, gosh, do something; do something that has some impact now and I keep getting back down to either we do something that is so arbitrary that we will create a whole new set of inequities or we get down to the question of low-income energy assistance payments, which we could do quickly.

Mr. Brandon. If I could add one more point on this. It has been alluded to that the mix of the gas is the problem here. The fact that there is old gas available and it is not being delivered, that is the problem and that if it is true, there is less old gas being delivered. But it is because of the contractual arrangements, and I think that does have to be addressed, and new gas is being substituted for even more expensive 107 gas.

The Chairman. There is no question that is occurring and we could even point to a variety of reasons why it is happening, but I can't find the solution that we could apply very quickly and that is the source of my question. Is there a solution that we can apply quickly?

Mr. Schachman. Mr. Chairman, even assuming the unlikely scenario, there was no court challenge, it is our belief by the time the pipelines went through the mix and filed their PGA's with FERC and FERC was to pass on them as quickly as possible for every interstate pipeline in the country, obviously that is going to take time, and then inform the distribution companies which must file with their commissions, and they would act as rapidly as possible and in lowering the prices, I still believe that as I said, putting the court scenario aside, which I believe is unlikely, you are looking at the earliest mid-March, probably mid-April until there is an effect at the burner tip.

That is why AGD is strongly urging this committee not to take that solution, which I realize would be the easier one to go home with for Christmas with the letters you are receiving from your constituents. But I can assure you that as president of a distribution company, we are getting the same reaction from our constituents.

The Chairman. I thought maybe you were putting postcards in with your bills, postcards to Congressmen and Senators.

Mr. Schachman. This is the first time in a number of years where we have come to Washington and had a companion. Because generally the customers look at one place and that is the distribution company. They really do not know about the pipelines and the producers.

I think that the beneficial aspect is that the Senate and the House now are indicating something will have to be done and it will have to be done shortly. I believe the immediate solution is low-income energy assistance.

The CHAIRMAN. Thank you very much. Are there further comments on that?

Mr. COOPER. On that point, yes, Mr. CHAIRMAN. I think probably, constitutionally the Congress can abrogate a contract or a type of contract which it finds to be completely against public policy. It can abrogate that kind of a contract, if it makes the necessary findings and says such and such a contract is so bad that we abrogate it as a matter of public policy.

We do not think take-or-pay clauses across the board fall into that type of category and so we do not favor the abrogation of take-or-pay clauses. But I think you could do it. On the other hand, I don't think it will do any good for this winter and I think that Congress will be falling into a trap if it abrogated all take-or-pay clauses if that were the right thing to do, and we don't think so.

But it would fall into a trap of having done something which would cause a lot of people a lot of harm and not benefit the consumer. It is too late. You can't do anything now which is going to help the gas bills at the burner tip during this coming winter. So we think there are other solutions for take-or-pay than abrogation.

The CHAIRMAN. Again, those are not short term?

Mr. COOPER. Those are not short term. We think it is going to take a while to solve that problem. We can also discuss price redetermination clauses, but that is outside the scope of your question.

Mr. ELAM. Mr. Chairman, all I know for you to do is to throw money at it if you want to do something in a hurry. In other words, Federal deficit sharing. The last time you did it—and I am not making light of this in any sense of the word—the last time you did it we had people in Greensboro, N.C. living in subsidized public housing for the elderly where the price of fuel was included in their rent and they received checks for a couple hundred dollars and went out and bought themselves some new dresses.

This is good; old people ought to look nice and I am all in favor of that, but it does not accomplish the purpose and there is going to be a certain amount of slippage in whatever you do. Now, we have litigated in this area. I am thinking of the prudency test now, which I think may have been in the back of your mind when you posed this question. I would like Mr. Grenier, who is counsel for the Process Gas Consumers group, to comment on this, if he may.

Mr. GRENIER. Thank you, Mr. CHAIRMAN. As Mr. Elam pointed out, we have suggested to the FERC that they do have adequate power under the fraud abuse standard in 601 to police the gas purchasing practices of the pipelines. Right now they disagree and we are now taking that issue to court. But the Commission itself now has indicated that it is willing to look at the gas purchasing practices of the pipelines in the context of the general rate case, where they can affect the rate of return and they can give the pipelines some incentives to behave.

We think that is a good, but unfortunately longer term solution to this problem. I am afraid we have to agree too there is no short term, quick fix that you can do right now in terms of fooling around with contracts. We have put what we believe is a comprehensive frame work in our statement, which we can build upon and which ultimately would give the parties an opportunity, in fact, an inducement to renegotiate the contracts, so that we can achieve full deregulation.

The CHAIRMAN. Thank you very much. Mr. Perry.

Mr. PERRY. We have nothing to add to any of your questions.

The CHAIRMAN. Thank you very much. One other solution has been suggested. Again, it is arbitrary and undoubtedly would not fit everyone equally and that is the percentage reduction involved on take-or-pay contracts or percentage elimination. Is that something that has any promise or is it in itself inequitable?

Mr. GOOCH. My name is Gordon Gooch, Mr. Chairman. At the panel before when you were unavoidably out of the chair, it was pointed out by a witness on the previous panel, Mr. McLelland of Valero, that such a system had been in place in the State of Texas and has worked successfully. It is entirely possible that should the Congress decide to make some adjustment to contracts, that some form or ratable sharing, where the Canadians, the Mexicans and the Algerians, the pipelines' own production, the pipelines' own affiliates and all could be taken into the same proportionate category there are some people who are looking into that possibility.

The CHAIRMAN. Any further comments from the panel?

Mr. ELAM. I would like to say that you are still talking about broad national averages and I come back to the point I tried to make earlier, where there are a lot of small businesses involved and average may not work for them.

Mr. COOPER. On this, Mr. Chairman, ratable taking operates well in production as a general matter, but, again, I don't—and that may be something you will want to consider. We don't think that should be applied, but that is something you may want to consider. But, again, if you were to impose some sort of a ratable take in this Congress right now, that is not going to help this winter. It may be something you want to study, but it is not a quick fix solution that is going to work.

Mr. SCHACHMAN. Sir, I think a modification of what you are suggesting, AGD has never advocated a total abrogation of take-or-pay clauses. We think that a percentage at which they can be set should be limited much below 90 to 100 percent, which we see now today in the marketplace, and that would definitely give the flexibility to the market.

The CHAIRMAN. To relate that question to the earlier question that I asked, can Congress by statute mandate that without invoking due process questions?

Mr. SCHACHMAN. I believe they did something very similar in the 1978 Act, in NGPA when we talked about interstate gas. I think section 105 may have a clause in there which a lot of people would interpret as being similar to the type of discussion we are having today and that still stands. So I believe, yes, it can be. I would say, obviously, it dictates the solution would be broken down in parts and they should be severable and there are methods to have these things tested quickly through the courts, if you so decide.

Your very question, I think, goes back to the point that we made earlier there is no quick solution. It is going to take some study; it is going to take some time.

If I may, one other point that has been raised by this panel, which does concern me, the discussion of buyers and sellers, whether it is a buyers' market or a sellers' market it can take care of itself. That is true of the buyer, the real buyer in the marketplace. A distribution company is not in the marketplace. It is the pipeline that does not have the incentive, who is purchasing the gas, passing those prices on to the distributors.

The distributors have to defend them at the State level. Unless the distributor can be in the arena, we do not have buyers and sellers protecting themselves. It may be true for a direct customer, but it is not true for distribution companies.

So if we are going to have a free marketplace, please give the buyer an equal tool to the sellers.

Mr. ELAM. Mr. Chairman, he was taking issue with me. May I make a comment on that? Item 5 that I was able to get in before you adjourned was that you provide expanded access to natural gas supplies by all pipelines, distribution companies, and end users. What I said was in the context of that proposal that we are making to you.

The CHAIRMAN. Gentlemen, thank you very much for your testimony. I suspect that in some respects you have clarified the issues, but in many respects you indicated you cannot do it. But I do appreciate your testimony. We will weigh your full statements. I appreciate your forbearance in waiting until this hour to be given the opportunity to complete your statements.

There are a number of questions which may be submitted by various members of the committee for responses in writing and I hope that you can respond to those as quickly as possible and in no event less than 10 days from the date you receive those questions so we may complete the record and so other people may have the benefit in the written form of the record of the knowledge embodied in those responses.

Thank you all very much.

We have one further request to testify. Senator Specter has asked that he be permitted to appear as a witness and I ask him to come forward.

Senator Specter, I am pleased that you are able to be here, as you were unable to be here earlier when your colleagues were present.

STATEMENT OF HON. ARLEN SPECTER, A U.S. SENATOR FROM THE STATE OF PENNSYLVANIA

Senator SPECTER. Thank you very much, Mr. Chairman, for affording me this opportunity to testify. I shall do so relatively briefly. I want to start by commending you, Mr. Chairman, and this committee for scheduling these hearings on such short notice. I regret that I could not be present this morning at the start of these hearings, but other commitments precluded that. But consistent with the full record and the diligence with which this Chairman is noted for, the distinguished Senator from Idaho, Mr. McClure, and this committee, your hearing has run well into the day and the hour is now past 3, so that I have been able to appear in time to say a few words on this subject.

The record is already replete with testimony about the severe impact on consumers, both home users and businesses, and I would add to that my own personal experience on travels through Pennsylvania during the course of the current fall season into the winter on so many complaints, which I have heard from consumers in homes and from consumers in small businesses.

Typical of the consumers in business was one in Pottsville, Pa., where a firm employed less than 400 people and had an increase in its September natural gas bill in the range of $35,000. I have had many complaints from individuals and groups of consumers. Pennsylvania is a State which has 1.8 million homes heated by natural gas and the situation is really in the nature of a natural emergency, which I do believe requires action.

It is a much more complex issue as to what that action should be. I heard the latter part of the panel which just concluded and the contention was raised that there is not sufficient time to do anything about existing contracts to help people now. My own sense is that something could be done now, that given the abilities to recompute contracts and with the computer age we are in, I would think that if we can find a fair and equitable approach, that it can be implemented. The mathematics can be worked out.

I do not say that with total assurance, because I do realize that it is an enormously complex subject, but that is my sense of it. I am concerned about the sanctity of contracts and said so in my prepared statement.

I have introduced legislation, which I did a week ago today, Senate Bill 3076, which was drafted by the Northeast Midwest Institute and I did so in my capacity as cochairman of the Northeast Midwest Coalition. The essence of that bill would be to suspend take-or-pay contracts until November 1, 1983.

When introducing that bill, I articulated reservations which I had in terms of the abrogation of contracts, because I do think that those who have gone in for production and reliance on that law have a strong basis for contending that there is an element of unfairness in what is being done.

In a private discussion with you, Mr. Chairman, during the break when we voted on the Cloucher issue, I discussed with you the question as to whether there would be bankruptcy or severe financial hardship on gas producers. I think to the extent that a factual record is established for that that this committee and the Congress ought to take that into account. It is hard to deal with that in terms of due process hearings.

My own sense again is that something could be worked out in that sense. I believe that there are precedents where it is constitutional to abrogate contracts, where there is a severe hardship or national emergency which warrants that. There would be an attack on grounds of equal protection possible where some contracts were abrogated and others were not. The equal protection standard, I think, would be upheld if there were a rational basis for distinguishing between or among those contracts and I think that that would be present.

In terms of whether there could be a result now and hearings later, my sense is that we could structure something, a fund, which would enable us to suspend the contracts now and to create a fund which would compensate those who could show the hardship or bankruptcy.

It may well be, Mr. Chairman, that we are going to face a balancing of bankruptcies, as between small businesses, like the one I referred to in Pottsville, contrasted with the natural gas producers, we may face a balancing of bankruptcies on home consumers. The balance, my sense is, that something has to be done to protect the consumer at this stage.

I leave you essentially with two points and that is my sense of urgency that I have seen on the faces of Pennsylvanians, whom I have talked to; and, second, my sense of legal judgment, having been in related problems for a long while that the legality can be worked out on a constitutional basis.

Again, Mr. Chairman, I thank you for your extraordinarily hard work and diligence in sitting so late, which has afforded me this opportunity to come in and say these few words for the record. Thank you very much.

[The prepared statement of Senator Specter follows:]

STATEMENT OF HON. ARLEN SPECTER, A U.S. SENATOR FROM THE STATE OF PENNSYLVANIA

In my capacity as co-chairman of the Northeast-Midwest coalition in the United States Senate, I have introduced S. 3076, the temporary Natural Gas Market Correction Act of 1982. I sponsored this legislation drafted by the Northeast-Midwest Institute because I believe that some action must be taken to address the urgent natural gas problem.

I am convinced, as a result of my travels in Pennsylvania and from thousands of letters from constituents, that some relief must be provided from the harsh increases in the costs of natural gas. One only needs a rudimental understanding of this complex issue to realize that, with prices escalating while a surplus of natural gas exists, something has gone awry with the Natural Gas Policy Act.

The Citizen Labor Energy Coalition reported in September that natural gas customers in 26 States, including Pennsylvania, will see their bills rise by $2.3 billion over the next 6 months. A recent article in the Oil Daily States that consumers can expect to pay as much as 120 percent more for natural gas this winter than they paid last year. These figures are even more illustrative when one considers that, since deregulation began in 1979, the average producer price for natural gas leaped 130 percent—$2.63 per thousand cubic feet to $6.25 per thousand cubic feet.

Closer to home, the 1.8 million households in Pennsylvania that use natural gas will pay $165 million more this winter than they did last year. The Pennsylvania Manufacturers Coalition on energy estimates a possible loss of 50 thousand jobs in Pennsylvania if the proposed increases ranging up to 38 percent become a reality. That 50 thousand figure could easily rise to a significantly higher number given the current economic conditions.

Perhaps most important to bear in mind is the effect that these drastic price hikes have on the low income and elderly. The Pennsylvania Consumer Advocate Office informs me that a person with a monthly income of $418 dollars will spend 35 percent of it on natural gas. An elderly woman receiving $316 from social security will be paying 46 percent of her income just for heating her home. To put it another way, wages for manufacturing jobs in Pennsylvania have increased 30 percent since 1979. During this same period, however, natural gas prices have increased over 130 percent. Even with greater funding available for low income energy assistance, this situation has reached crisis proportions for too many households.

As I stated last week when I introduced this measure, I have reservations about a bill which proposes to make fundamental changes from prior legislation on which explorers and producers have relied. Yet the importance of this matter is so great, and the need for dialog so compelling, that I have presented the committee with this bill with the hope that it may be a positive contribution to the debate before us today. I am pleased to have this opportunity to testify and very thankful to Senator McClure for scheduling this hearing. It is clear that this issue, complex as natural gas is, deserves the benefit of hearings, including testimony from the involved participants.

The bill that I have sponsored represents a temporary approach for dealing with the existing inconsistencies in the natural gas market. I request that the committee examine this legislation carefully. In evaluating the propriety of suspending existing contracts, it is important to know what the effects will be on gas producers in terms of financial hardship or even possible bankruptcies. From the consumers point of view there should be an evaluation of the financial hardship on homeowners and the possibility of bankruptcies of business—either large or small businesses.

In my judgment, the Congress should proceed with extreme caution in abrogating or suspending contracts. That should be done only on a strong showing that the national health and welfare mandate elevating the interests of the consumers over the existing contractual rights of the producers. A final judgment on the issue of such short-term suspension of contracts may depend on the balancing of bankruptcies as to gas producers versus the business gas consumers, and whether residential consumers can both heat and eat.

Hearings can shed considerable light on these critical factual questions. It may be that this bill should be amended to permit exceptions to suspensions of contracts where producers can show extreme financial hardship or the imminence of bankruptcies. I believe the introduction of this bill will aid the hearing process and assist in finding both short and long term answers to the complex issues involved in our national natural gas policy.

I cannot overstate the critical nature of the current natural gas situation. I am optimistic that today's discussions will be fruitful in determining the manner in which this problem ought to be addressed.

The **Chairman**. Thank you very much, Senator.

I know of no other witnesses who wish to appear and testify at this time. I have no questions of Senator Specter. Those other matters that have been submitted and questions that will be submitted will be made a part of the record when they are received.

I thank all witnesses. With that the committee stands adjourned.

[Whereupon, at 3:10 p.m., the committee adjourned.]

APPENDIXES

APPENDIX I

Responses to Additional Committee Questions

JAMES A. MC CLURE, IDAHO, CHAIRMAN
MARK O. HATFIELD, OREG.
LOWELL P. WEICKER, JR., CONN.
PETE V. DOMENICI, N. MEX.
MALCOLM WALLOP, WYO.
JOHN W. WARNER, VA.
GORDON J. HUMPHREY, N.H.
FRANK H. MURKOWSKI, ALASKA
DON NICKLES, OKLA.
JOHN P. EAST, N.C.
JOHN HEINZ, PA.
HENRY M. JACKSON, WASH.
J. BENNETT JOHNSTON, LA.
DALE BUMPERS, ARK.
WENDELL H. FORD, KY.
HOWARD M. METZENBAUM, OHIO
SPARK M. MATSUNAGA, HAWAII
JOHN MELCHER, MONT.
PAUL E. TSONGAS, MASS.
BILL BRADLEY, N.J.

MICHAEL D. HATHAWAY, STAFF DIRECTOR
CHARLES A. TRABANDT, CHIEF COUNSEL
D. MICHAEL HARVEY, CHIEF COUNSEL FOR THE MINORITY

United States Senate
COMMITTEE ON
ENERGY AND NATURAL RESOURCES
WASHINGTON, D.C. 20510

January 3, 1983

Mr. Nicholas J. Bush, President
Natural Gas Supply Association
1730 Rhode Island Avenue, N.W.
Suite 200
Washington, D.C. 20036

Dear Mr. Bush:

Attached are questions in follow-up to your appearance at the Committee's December 13, 1982 hearing on current conditions in the natural gas market. Please provide your responses to these questions to the Committee not later than the close of business January 17, 1983. If any clarification is needed you may contact Mr. Howard Useem (202-224-5205) of the Committee staff.

Sincerely,

James A. McClure

James A. McClure
Chairman

Enclosures

JAM:HU

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QUESTIONS FROM REPUBLICAN MEMBERS OF THE COMMITTEE

1. In the Natural Gas Supply Association's opinion, what impact would the various proposals currently pending before the Committee*/ have on:

   --residential, commercial and industrial gas prices?
   --short-term and long-term gas supplies?
   --the financial situation of producers, pipelines and gas distribution companies?

2. In NGSA's opinion, to what extent and on what matters does the Federal Energy Regulatory Commission have the statutory authority to take action to address current and potential future problems in the gas market? Please provide the Committee with a detailed legal analysis of the FERC's authority. What actions would you recommend that the FERC take?

3. The following statement appears on page 14 of NGSA's prepared testimony:

   > The deep-cushion pipeline will continue to have an advantage in bidding for uncommitted gas. In addition, it will have another advantage that did not exist under the NGPA. It would continue to have gas committed to its system without any obligation to purchase it. This gas may, in fact, be cheaper than uncommitted gas on which a shallow-cushion pipeline is bidding.

   Q. Would you please identify the gas that would be commited to the deep-cushion pipeline, and fully explain the facts and reasoning that support the statement contained in the paragraph.

4. If the Congress were to enact a law permitting pipelines to abrogate take-or-pay provisions in producer-pipeline contracts, but also permitting producers to sell to other purchasers the volumes of gas not taken as a result of the contract modifications, would the producers who could not sell those volumes be entitled to compensation for such lost sales, even though they retained the gas and were contractually free to sell it at a later date? If they are entitled to compensation, how would it be computed, and who would pay it?

---

*/ S. 2074; S. 2892; S. 3028; S. 3054; S. 3069; S. 3070; S. 3076; S. 3088.

5. Under existing law, does the FERC have the authority to deny outright the pass-through of purchased gas costs attributable to wellhead purchases that exceed an arbitrary take-or-pay limit, such as 75 percent?

6. On page 12, the NGSA states that the solution to the problem is "to abolish the artifical and meaningless price differentials for a fungible and homogeneous commodity."

   Q. If you are advocating decontrol of gas prices and no modifications in the provisions of existing gas purchase contracts, would not the inevitable result be a substantial short-term increase in wellhead prices, pipeline purchased gas costs, and retail gas prices?

   Q. After that increase occurs, would it not take many months, if not years, before a long-term decline in gas prices would commence, because considerable time would elapse before there would be a significant price effect resulting from the renegotiation of existing contracts and the signing of new contracts, with much reduced gas price provisions. If you disagree please explain.

   Q. If you contend that immediate decontrol would result in an immediate reduction in retail gas prices, please provide a detailed explanation.

QUESTIONS FROM DEMOCRATIC MEMBERS OF THE COMMITTEE

QUESTIONS FOR NATURAL GAS SUPPLY ASSOC. (NICK BUSH)

1. Why wasn't your testimony here 24 hours in advance, in compliance with the Committee's rules? I was looking forward to reading it over the weekend, but it didn't arrive until 8:45 this morning.

Official Committee File
Please Return

NATURAL GAS SUPPLY ASSOCIATION

1730 Rhode Island Avenue, N.W.
Suite 200
Washington, DC 20036
(202) 331-8900

Nicholas J. Bush
President

SENATE COMMITTEE ON
ENERGY AND NATURAL RESOURCES
RECEIVED
JAN 18 1983
WASHINGTON, D.C. 20510

January 17, 1983

The Honorable James A. McClure
Chairman
Energy and Natural Resources Committee
3104 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

Enclosed are the responses to the questions submitted to this Association by the Republican and Democratic members of your Committee in consequence of our testimony at the December 13 hearing. The replies to two additional questions asked by Senator Domenici during the course of the hearing are in the final stages of preparation and will be supplied to you in the very near future.

Please let us know if the Natural Gas Supply Association can assist you in any other way as you continue your review of current natural gas pricing policy and appropriate changes.

Sincerely,

Nicholas J. Bush

Nicholas J. Bush

NJB:jct

Enclosures

January 17, 1982

Questions by Republican Members of the Senate Energy Committee to the Natural Gas Supply Association and the Natural Gas Supply Association's Answers Thereto

1. In the Natural Gas Supply Association's opinion, what impact would the various proposals currently pending before the Committee*/ have on:

   (a) --residential, commercial and industrial gas prices?
   (b) --short-term and long-term gas supplies?
   (c) --the financial situation of producers, pipelines and gas distribution companies?

ANSWER

S. 2074. This bill would phase up the price of currently regulated gas to an oil reference price (70% of the price of crude oil over two years), deregulate gas from wells drilled after enactment (subject to the oil reference price in 1983 and 1984), and deregulate all gas on January 1, 1985.

The Association believes that this bill would tend to move wellhead gas prices to market clearing levels. The impact on gas prices at the residential, commercial and industrial level will be determined by consumers based on their willingness to purchase this fuel when compared to the prices of other fuel sources. S. 2074 should improve both the short term and long term gas supplies, since producers will have, for the first time since 1954, a clear picture of the market value of natural gas and can make investment decisions to

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*/ S. 2074; S. 2892; S. 3028; S. 3054; S. 3069; S. 3070; S. 3076; S. 3088.

develop new reserves based on the demands of the marketplace. The financial situation of producers, pipelines and distribution companies should become stable under S. 2074. The profitability of each element of the industry should adjust to each company's ability to raise capital for further investment.

S. 2892. This bill which expands the definition of "abuse" under NGPA Section 601(c) is designed to hold down retail prices by limiting a pipeline's ability to pass through gas purchased under contracts which contain high take-or-pay provisions, which contain indefinite price clauses not tied to an economic indicator, which contain favored nations clauses that set the price to the highest price in a production area, or which fail to contain a market-out clause. Such a bill might accomplish its objective in the short term, but over the long term would soon result in much higher prices to residential, commercial and industrial users.

This bill would drastically impact the supply of natural gas available to consumers. By prohibiting the pass-through of gas purchase costs, pipeline purchasers would either have to honor their contractual obligations and pay for the gas that they were unable to take and pass-through, or breach those contracts containing the prohibited provisions. In all events, producers would quickly be discouraged from further exploration when it became apparent that they were not to be assured of receiving a constant revenue stream sufficient to permit producers to service their debt or receive a return on their investment. To the extent that producers would be unable to adjust the price of their gas to the "going rate" in the marketplace under an indefinite price clause, they would be unwilling to sell the gas on a long term basis. Pipeline purchasers and their bankers could be disadvantaged if gas were to be sold on a short-term or spot basis. Financiers would have no assurance that adequate reserves were available to provide revenues to finance the pipeline. The net result of such a bill would be that less gas would be available in the years to come, and the financial position of many producers, pipelines and distributors would be worsened.

S. 3028. This bill is similar to S. 2892. It seeks to expand the definition of "abuse" under

Section 601(c) of the NGPA. It can be expected to have the same impact as that described for S. 2892.

S. 3054. This bill would impose a wellhead price freeze until January 1, 1985. It would extend NGPA price control for two additional years and would require pipelines to modify their take-or-pay obligations. A wellhead price freeze will not freeze consumer prices. Based upon most recent DOE data on average residential prices for the 12 month period ending July 1982, a price freeze during such period would have impacted the price by as little as 10% and not more than 18%. Among the reasons for consumer price increases not attributable to and unaffected by the wellhead price are the following:

a) Imports of Canadian gas which sells for more than twice the domestic average gas price and of LNG which sells for over 3 times the domestic average price.

b) Pipeline fixed transportation and distribution costs which must be averaged over smaller overall gas sales due to reduced demand under present economic conditions.

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c) Some pipelines have recently had an increase in their rates of return and have been allowed by the courts to price their own production at NGPA levels retroactive to December 1, 1978.

In the long run, a wellhead price freeze will undoubtedly lead to a reduction in gas exploration activity and an inevitable gas shortage. As in the past a reduction of supply will be reflected by curtailments and increased prices as further reliance upon non-domestic sources of gas and other fuels will be necessary to meet demand. Prices would rise as the fixed costs of transportation and distribution are spread over fewer units of gas sold.

The NGPA was passed after many months of extensive study and input by all segments of the gas industry. It is generally agreed that the NGPA has caused serious market disorder problems and inquiry by the appropriate congressional committees is on-going. This bill will only aggravate these problems and insure their perpetuation.

S. 3069. This legislation would impose a two year freeze on wellhead prices and extend controls for two years, just as would S. 2054. S. 3069 can be expected to have similar effects to S. 3054 upon retail prices, the supply outlook for natural gas and the financial situation which would face producers and pipelines.

S. 3070. This bill would abrogate take-or-pay clauses in all gas purchase contracts except in those individual cases where, after notice and evidentiary hearing, the FERC finds that operation of the clause is necessary to prevent loan default or to prevent a taking without fair compensation of the seller's property.

Abrogation of take-or-pay clauses will have little impact on retail prices. Take-or-pay provisions do not necessarily increase the cost of gas to the pipeline. A pipeline that makes a take-or-pay payment now has the right to make that gas up at a later date at no cost or with a small price differential if the contract price has increased. Most recent increases in retail gas cost are due to increases in pipeline and distribution costs, costs of LNG and gas imports, and the changing mix of natural gas as newer supplies replace older depleting reserves.

Take-or-pay clauses are necessary to allow the producer to receive a minimum steady cash flow and thus have a chance to recover his investment over a reasonable period. Abrogation of take-or-pay will cut off this necessary cash flow and cause producers to use available capital to service debt that otherwise could be put to use in exploration or development operations. In the absence of some reasonable revenue stream, lending institutions and investors will shy away from funding gas drilling projects. The effect of these factors will be a reduction in drilling activity and a failure to replace reserves currently being produced - thus insuring future supply shortages. Abrogation of take-or-pay will also have severe consequences for the financial situations of both producers and pipelines, for the same reasons as S. 3054.

S. 3076. This bill would give natural gas purchasers the right until November 1, 1983 to refuse to take delivery of any volume of natural gas under contract without any obligation to make "take-or-pay" payments, and attempts to deny pass-through of costs by any pipeline not buying the least-expensive natural gas available under existing contracts.

The abolition of "take-or-pay" clauses and the attempt to require pipelines to take the cheapest gas available from producers would not necessarily reduce retail prices, since they affect only one link in the gas production and distribution chain. The bill does not attempt to adjust the linkage between pipelines and distributors. Distributors would still be required to comply with "minimum bills" from pipelines which set the minimum purchase amount during a billing period -- generally without any make-up provision.

The requirement that a pipeline take the cheapest gas available to it under current contracts would require a pipeline to take 100% of all of the 20¢ gas available, then all of the 30¢ gas, $1.00 gas, etc. until its gas demands have been met. All of the more expensive high-cost contract gas, which the NGPA encouraged producers to drill at a cost of millions, would be shut-in. The enactment of legislation requiring pipelines to purchase the lowest priced gas available to them would eliminate the production from these costly wells with a zero return on such investments.

Requiring a pipeline to buy only the lowest-price gas available under current contracts may require the shut-in of oil production to the extent that the casinghead gas associated with such oil does not meet the least-cost criteria, resulting in more foreign oil imports and a consequent increase in consumer energy prices.

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The ability of pipelines to continue to purchase high cost Canadian and Mexican imports would further aggravate the problem, because pipelines would not be required to abrogate their contracts with foreign companies. Thus, they would continue to purchase high-priced gas (i.e., $4.94 per MMBtu) that has been contracted for from Canadian and Mexican producers. To the extent that pipelines continue to take 100% of the "take" requirements, additional domestic production will be shut-in. The cost of substantial volumes of the shut-in gas may be well below the cost of imports.

The least expensive gas requirement will also result in shortages. The current supply excess is primarily a function of reduced demand, which could quickly change as the economy recovers. Drilling rig use in 1982 dropped 40%. Domestic producers witnessing 100% shut-ins of recently drilled wells and realizing that further investment in gas exploration and production is subject to short term political considerations and that their return on investment is subject to spasmodic federal intervention will be disinterested in drilling additional wells. No producer, investor or banker could afford the risk of exploring for new reserves under such circumstances. If producers are reluctant to drill for new gas supplies, even for a few months, the supply implications for the future are obvious.

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Finally, this bill would have the same adverse effects on the financial situation of producers and pipelines as S. 3054 and S. 3070.

S. 3088. This bill is substantially the same as S. 3070 and can be expected to have essentially the same effect as that bill on retail prices, the supply outlook and the financial situation.

2. In NGSA's opinion, to what extent and on what matters does the Federal Energy Regulatory Commission have the statutory authority to take action to address current and potential future problems in the gas market? Please provide the Committee with a detailed legal analysis of the FERC's authority. What actions would you recommend that the FERC take?

ANSWER:

The NGSA refers to the Joint Comments of Indicated Producers before the Federal Energy Regulatory Commission in Docket No. RM 82-26 (Volume 1, pp. 94-132, dated August 26, 1982). In that submission the producers addressed the question of whether the FERC has the authority to suspend, temporarily or permanently, take-or-pay provisions, indefinite price clauses, and most favored nations clauses and the authority to impose so-called "market-out" clauses in contracts which do not now contain them. In that submission, producers took the position that the Commission has no legal authority under the NGPA, after the gas in a particular category is "decontrolled" or

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removed from its NGA jurisdiction to "suspend" any provisions in gas sales contracts entered into between gas producers and pipelines. While the Commission may have had authority under the NGA to suspend or render inoperative contract provisions as conditions to issue a certificate of public convenience and necessity under Section 7 (F.P.C. v. Texaco Inc., 377 U.S. 33 (1964)), once a certificate was issued the Commission lost the power to impose conditions affecting contract provisions (Shell Oil Co. v. F.P.C., 531 F.2d 1324, 1327 (5th Cir. 1976)).

3. The following statement appears on page 14 of NGSA's prepared testimony:

> The deep-cushion pipeline will continue to have an advantage in bidding for uncommitted gas. In addition, it will have another advantage that did not exist under the NGPA. It would continue to have gas committed to its system without any obligation to purchase it. This gas may, in fact, be cheaper that uncommitted gas on which a shallow-cushion pipeline is bidding.

Q. Would you please identify the gas that would be committed to the deep-cushion pipeline, and fully explain the facts and reasoning that support the statement contained in the paragraph.

ANSWER:

The paragraph quoted by the committee was intended to point out that there are some pipelines, certainly not all, that have contracts to purchase regulated old gas with low requirements for a minimum take or a minimum pay obligation. In such circumstances such a pipeline would have gas available to it which it chose not to

January 17, 1982

take. Nevertheless, such a pipeline could bid for new uncommitted gas at prices that are higher than the regulated low priced gas which it has under contract.

4. If the Congress were to enact a law permitting pipelines to abrogate take-or-pay provisions in producer-pipeline contracts, but also permitting producers to sell to other purchasers the volumes of gas not taken as a result of the contract modifications, would the producers who could not sell those volumes be entitled to compensation for such lost sales, even though they retained the gas and were contractually free to sell it at a later date? If they are entitled to compensation, how would it be computed, and who would pay it?

ANSWER

If Congress abrogated take-or-pay clauses and the producer were free to sell the gas to other purchasers to the extent that the gas is not sold to other purchasers, the producer should be entitled to compensation to cover his debt service, royalty and other expenses. Compensation should include a factor for storage of volumes that were contracted for by the original purchaser.

It should be remembered that a producer incurs, up front, all of his investment in leasing and developing each well. Should Congress abrogate the take-or-pay provision of the contract with a pipeline buyer, the parties may or may not still have a binding gas purchase contract depending on other contract provisions and litigation between the parties. Should

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the purchaser demand a given quantity at a later time, the producer may still be obligated to make delivery to the extent that the wells committed to the contract have the capacity to deliver the gas. In such a circumstance, the pipeline purchaser would have free storage for the contracted gas unless compensation was provided.

The appropriate computation of compensation under such circumstances should be appropriately reached by negotiations between the affected parties.

5. Under existing law, does the FERC have the authority to deny outright the pass-through of purchased gas costs attributable to wellhead purchases that exceed an arbitrary take-or-pay limit, such as 75 percent?

ANSWER

It is our understanding of existing law that FERC does not have the authority to deny outright pass-through of purchased gas costs attributable to wellhead purchases that exceed an arbitrary take-or-pay limit. Interpretation of existing law under these circumstances is the responsibility of the Commission and ultimately the judiciary.

6. On page 12, the NGSA states that the solution to the problem is "to abolish the artificial and meaningless price differentials for a fungible and homogeneous commodity."

January 17, 1982

Q. If you are advocating decontrol of gas prices and no modificiations in the provisions of existing gas purchase contracts, would not the inevitable result be a substantial short-term increase in wellhead prices, pipeline purchased gas costs, and retail gas prices?

ANSWER

It is impossible to give a categorical answer to this question because of the diversity among the various pipeline purchasers. To the extent that a pipeline has a large proportion of old regulated gas and if such gas remains under controls, then such a pipeline would be able to pay higher prices for new uncommitted gas than could a pipeline with little or no regulated old gas under contract. If, on the other hand, all gas is deregulated the prices paid at the wellhead should quickly adjust to a market level based on the supply and demand for gas rather promptly as buyers and sellers adjust to market realities. To the extent that indefinite price escalators might cause prices to increase rapidly in the short term, we believe that the buyers and sellers of gas subject to these provisions would be forced promptly to renegotiate those provisions in order to reflect market realities.

Further, it should be noted that the wellhead price is only one component of the total price paid by consumers. Other factors include costs and rates of return of pipeline and distribution companies.

January 17, 1982

We should point out that the cost of drilling for new reserves continues to increase, as the amount of gas found per foot drilling has shown no evidence of decline. Accordingly, the price of gas is likely to continue to rise subject to the discipline of market forces.

Q. After that increase occurs, would it not take many months, if not years, before a long-term decline in gas prices would commence, because considerable time would elapse before there would be a significant price effect resulting from the renegotiation of existing contracts and the signing of new contracts, with much reduced gas provisions? If you disagree, please explain.

ANSWER

We disagree for the reasons stated in the answer to the preceding question. Even under the existing provisions of the Natural Gas Policy Act producers and pipelines have been and are continuing to adjust their contract provisions to reflect current market realities. There is no reason to believe that given an opportunity for free market forces to act, that price levels should not quickly adjust to the disciplines of the marketplace.

Q. If you contend that immediate decontrol would result in an immediate reduction in retail gas prices, please provide a detailed explanation.

January 17, 1982

ANSWER

The NGSA does not contend that immediate decontrol will result in an immediate reduction in retail gas prices. Attempts have been made by others to predict what the market value of gas would be in a deregulated environment. Some have suggested that retail prices will go down, others have suggested that prices will remain about the same, while still others have indicated that prices will rise. The NGSA does contend that the price levels for the commodity will quickly reach a market determined level based on the ability of natural gas to compete with alternate sources of energy. Whether that price is higher or lower than at present will be determined by the millions of consumers of natural gas.

January 17, 1982

Question by Democratic Members of the Senate Energy Committee to the Natural Gas Supply Association and the Natural Gas Supply Association's Answer Thereto

1. Why wasn't your testimony here 24 hours in advance, in compliance with the Committee's rules? I was looking forward to reading it over the weekend, but it didn't arrive until 8:45 this morning.

ANSWER

We did not complete the Association's testimony until late Sunday evening. We did, however, request and receive the approval of the Chairman's staff to supply the testimony as soon as possible on Monday morning.

It is our understanding that this courtesy is similar to courtesies that we and other witnesses experienced under Democratic leadership of the Committee. Given the short deadline on which Senate hearings are often scheduled, such courtesies are essential if witnesses are to have sufficient time to prepare meaningful, substantive testimony.

ANSWERS TO QUESTIONS FROM SENATOR DOMENICI AT THE DECEMBER 13, 1982 HEARING

Question: What would be the short-term price impact in the next three or four months if the Eagleton, Danforth or Kassebaum bills had passed in the lame duck session?

Answer: It is impossible to estimate the dollar impact of these bills on a residential user's gas bill during the next few months.

We stated in our testimony on December 13, 1982 that it was highly unlikely that the pending legislative proposals would afford any immediate price relief to residential gas customers. We went on to note that if any of the proposed bills were enacted the price impact on residential gas customers would be adverse in the intermediate to long-term.

Similar views were expressed by other witnesses at the December 13, 1982 hearing. For example, Jerome McGrath of the Interstate Natural Gas Association of America noted that there was no hard evidence that gas prices would decline substantially if take-or-pay constraints were removed. The testimony of the Coalition of Intrastate Pipelines indicated that enactment of any of the proposed bills was not likely to result in immediate consumer price relief.

Finally, we do not believe that abrogation of the take-or-pay clauses as provided by the Danforth bill would have any short-term impact on residential gas bills, since implementation of the proposal would require six to twelve months.

2. GAS WELL DRILLING ACTIVITY SINCE THE NGPA OF 1978

TOTAL WELLS(1)

	1979	1980	1981	1982*
Exploratory	1,784	1,969	2,366	2,267
Developmental	12,897	13,761	15,528	16,690
Total	14,681	15,730	17,894	18,956

BREAKDOWN BY DEPTH

	1979(2)	1980	1981	1982 (Jan.-Sept. Only)
Above 15,000 ft.	13,786	15,408	17,462	13,719
Below 15,000 ft.	293	322	432	408
EXPLORATORY				
Above 15,000 ft.	N.A.	1,860	2,211	1,595
Below 15,000 ft.	N.A.	109	155	102
DEVELOPMENTAL				
Above 15,000 ft.	N.A.	13,548	15,251	12,124
Below 15,000 ft.	N.A.	213	277	306

COSTS

	1979	1980	1981	1982
Average Cost/Well	$443,080	$536,402	$698,576	N.A.
Ave. Cost/Expl. Well	727,100	962,861	1,327,036	N.A.
Ave. Cost/Dev. Well	401,710	463,688	597,652	N.A.

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1. API, Quarterly Statistics
2. 1979 Breakdown, Joint Assoc. Drilling Survey

* Preliminary

BREAKDOWN BY DEPTH
(Average Cost Per Well)

Depth Interval	1979	1980	1981	1982
0 - 1,249	28,150	33,326	45,783	N.A.
1,250 - 2,499	63,570	71,053	80,016	N.A.
2,500 - 3,749	106,909	131,870	150,280	N.A.
3,750 - 4,999	148,336	176,412	205,612	N.A.
5,000 - 7,499	293,021	344,937	416,199	N.A.
7,500 - 9,999	732,112	774,025	943,823	N.A.
10,000 -12,499	1,264,331	1,428,550	1,803,737	N.A.
12,500 -14,999	2,044,331	2,426,010	3,096,781	N.A.
15,000 -17,499	3,169,246	3,750,033	5,078,961	N.A.
17,500 -19,999	4,403,905	5,572,420	8,046,313	N.A.
20,000 & Over	8,453,415	8,381,150	9,711,230	N.A.

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United States Senate
COMMITTEE ON
ENERGY AND NATURAL RESOURCES
WASHINGTON, D.C. 20510

January 3, 1983

Mr. Jerome J. McGrath, President
Interstate Natural Gas Association of America
1660 L Street, N.W.
Washington, D.C. 20036

Dear Mr. McGrath:

Attached are questions in follow-up to your appearance at the Committee's December 13, 1982 hearing on current conditions in the natural gas market. Please provide your responses to these questions to the Committee not later than the close of business January 17, 1983. If any clarification is needed you may contact Mr. Howard Useem (202-224-5205) of the Committee staff.

Sincerely,

James A. McClure

James A. McClure
Chairman

Enclosures

JAM:HU

QUESTIONS FROM REPUBLICAN MEMBERS OF THE COMMITTEE

1. In INGAA's opinion, to what extent and on what matters does the Federal Energy Regulatory Commission have the statutory authority to take action to address current and potential future problems in the gas market? Please provide the Committee with a detailed legal analysis of the FERC's authority. What actions would you recommend that the FERC take?

2. There have been numerous charges that the laws of supply and demand do not operate in the gas market; cited as evidence for this are the continuous increases in gas prices in the face of an apparent surplus of gas.

   Q. How do you explain this apparent failure of the laws of supply and demand?

   Q. To what extent is the regulatory structure responsible for these results?

3. It is noted on page 10 of INGAA's testimony that the "basic cause of gas price increases is the change in mix of gas supplies under the NGPA."

   Q. To what extent then, would the various proposals currently pending before the Committee*/ reduce or moderate the increase in residential gas prices if any or all were adopted?

4. What impact would the various proposals currently pending before the Committee */ have on:

   --residential, commercial and industrial gas prices?
   --short-term and long-term gas supplies?
   --the financial situation of interstate gas pipelines?

5. What impact would enactment of the proposals currently pending before the Committee*/ have on the producer/pipeline renegotiations which are currently underway?

*/ S. 2074; S. 2892; S. 3028; S. 3054; S. 3069; S. 3070; S. 3076; S. 3088.

QUESTIONS FROM DEMOCRATIC MEMBERS OF THE COMMITTEE

QUESTIONS FOR INGAA (JERRY McGrath)

1. Your statement says that "A major cause of the price increase is the shift in volumes from lower-cost NGPA categories to higher-cost NGPA categories. This shift is predominantly due to the natural decline of old gas." (Page 7) Do you have any statistical evidence to substantiate that? Are you sure it is not due to lower takes (due to take or pay provisions) of old gas?

2. You say (on page 8) that the EIA data "suggest that the highest cost gas does not, on average, have the highest take requirements." You use the word "suggest" -- how can we be sure?

3. The producers oppose doing anything to defuse take or pay requirements, or to freeze prices, saying the industry will work things out. What evidence do you have that contract renegotiations are occurring? Have you surveyed your members to see what's happening? Will you do so?

INGAA

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SENATE COMMITTEE ON
ENERGY AND NATURAL RESOURCES
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January 21, 1983

The Honorable James A. McClure
Chairman, Committee on Energy and Natural Resources
United States Senate
Washington, D.C. 20510

Dear Senator McClure:

Enclosed are my responses on behalf of the Interstate Natural Gas Association of America to the questions you forwarded to me earlier this month. We appreciate the opportunity to be able to supply this information and hope you will find it helpful.

If you have any further questions, we shall be happy to respond to them.

Yours truly,

Jerome J. McGrath

Jerome J. McGrath
President

JJM:lh
Enclosures

cc: Senate Energy Committee

INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA
1660 L STREET, NORTHWEST, WASHINGTON, D.C. 20036, TELEPHONE 202 293-5770

January 17, 1983

Q. In INGAA's opinion, to what extent and on what matters does the Federal Energy Regulatory Commission have the statutory authority to take action to address current and potential future problems in the gas market? Please provide the Committee with a detailed legal analysis of the FERC's authority. What actions would you recommend that the FERC take?

A. In April of last year the Federal Energy Regulatory Commission (FERC or Commission) issued a Notice of Inquiry (NOI) for the purpose of gathering information concerning alleged market ordering problems caused by or resulting from, among other things, its administration of the Natural Gas Act (NGA) and the Natural Gas Policy Act (NGPA). The Commission sought responses as to the extent of administrative authority available to it to resolve these problems along with the commentors' opinions as to the advantages and disadvantages of attempting such action. Included in the Commission's questions were those which related to various contract clauses pertaining to indefinite price escalation (IPE), take-or-pay, and market/contract-out. In responding to these questions INGAA noted that prior to enactment of the NGPA, the FPC had broad authority under its NGA jurisdiction to determine whether contracts were "unjust, unreasonable, unduly discriminatory or preferential." The courts recognized this broad authority over gas sales contracts and tariffs and the FPC's jurisdiction to determine whether rates fixed by jurisdictional contracts are just and reasonable. 1/ We noted that with regard to IPE clauses, that the FPC, in 1961, had declared such clauses would be deemed void as against public policy if contained in any contract executed on or after April 3, 1961. 2/ The

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1/ See, for example, *Pacific Gas Transmission Co.* v. *FPC*, 536 F.2d 393 (D.C. Cir., 1976), *cert.* denied, 429 U.S. 999 (1976); *City of Chicago* v. *FPC*, 488 F.2d 731 (D.C. Cir., 1971), *cert.* denied, 405 U.S. 1074 (1972).

2/ Order No. 232-A, 25 FPC 609 (1961).

following year, the FPC issued a policy statement declaring its intention to reject contracts containing IPE clauses executed on or after April 2, 1962. 3/ The Supreme Court upheld the FPC's legal authority to impose these limitations on IPE clauses. 4/

The FERC's authority over IPE and other clauses was changed by the NGPA which removed various categories of gas from the FERC's jurisdiction and eliminated the FERC's jurisdiction over most other categories of gas on January 1, 1985. Specifically, Section 601(a) of the NGPA removes FERC jurisdiction over all gas which was not committed or dedicated to interstate commerce prior to November 9, 1978. In addition, all gas qualifying under Sections 102(c), 103(c), and 107(c)(1)(2)(3) and (4) has been removed from FERC jurisdiction under the NGA. This was recognized by the United States Court of Appeals for the Fifth Circuit recently when it considered the interrelationship between the FERC's NGA and NGPA jurisdiction. The Court stated that Section 601(a) of the NGPA "reduces the amount of gas subject to the NGA." Pennzoil v. FERC, 645 F.2d 360, 380 (5th Cir. 1981)

In the NOI, the FERC also sought comments on its autnority under Section 501(a) of the NGPA to modify or abrogate contracts. Section 501(a) simply allows the FERC to issue any rules and orders as "it may find necessary and appropriate to carry out its functions" under the NGPA. This is a procedural or remedial rule and cannot be interpreted to grant substantive powers which are not expressly provided for in the

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3/ Order No. 242, 27 FPC 339 (1962).

4/ FPC v. Texaco, 377 U.S. 33 (1964); Superior Oil Co. v. FPC, 322 F.2d 601 (1973), where the Court specifically held that the FPC's decision to restrict IPE clauses and most favored nation clauses was not an abuse of its authority under Section 5 of the NGA. See, also, the Supreme Court's opinion in the Permian case affirming the Commission's permanent ban on the operation of indefinite escalation clauses in all Permian Basin producer jurisdictional gas sales contracts.

NGPA. 5/ There is considerable legal precedent that the powers of an administrative agency are derived from the substantive provisions of the statute rather than the procedural or remedial sections. 6/

In INGAA's view, it would be difficult for the FERC to assert that one of its functions contemplated by Section 501(a) of the NGPA is the alleviation of alleged market ordering problems caused in large measure by the NGPA itself. In short, there must be "administrative fidelity to legislative command," and there is no such command to be derived from Section 501(a).

Accordingly, the FERC's authority to require, modify or abrogate clauses pertaining to IPE, take-or-pay and market out in contracts for "new gas" would assuredly be subject to legal challenge as would the FERC's authority to do so in existing contracts on a retroactive basis. 7/ The litigation would undoubtedly take several years before the issuance of non-appealable court orders. The result would be economic uncertainty amongst interstate natural gas pipelines and their suppliers which could well exacerbate existing market ordering problems.

INGAA submits that in light of the FERC's questionable legal authority and the time it would take in the courts to ascertain the extent of that authority, the better way to get a timely resolution of these

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5/ A review of the legislative history of the NGPA supports such a conclusion. The Conference Report indicates that the NGPA as originally passed in the House provided the FERC authority to issue rules to enforce compliance with the legislation and to define further the terms used. The Senate had no comparable provision. The Conference Report provides no further guidance except to state that the grant of authority includes the ability to issue regulations necessary to "prevent circumvention of the Act," to define terms and prescribe the forms of reports.

6/ 1 Am Jur 2d, Section 70, Administrative Law; Murphy Oil Corp. v. FPC, 431 F.2d 805 (8th Cir., 1970); Mobil Oil Corp. v. FPC, 483 F.2d 1238, 1257 (D.C. Cir., 1973).

7/ See Tennessee Gas Pipeline Co. v. FERC, 626 F.2d 1094, 1116 (D.C. Cir., 1979); cert. denied, 445 U.S. 920 (1980).

critically important contract problems that are or are threatening to cause further market disruption would be for the Congress to enact legislation which would incorporate the following principles:

1. Take-or-Pay - The maximum percentage for take-or-pay in existing contracts for gas-well-gas should be limited to 60% of deliverability for a period of three years from the effective date of the legislation. Take-or-pay payments will be made up from deliveries above 60% until fully recovered.

2. Section 107 Gas - Provision should be made to allow either party to a contract for Section 107 gas the discretion to terminate that contract within one year from the effective date of the legislation. If the contract is terminated, the purchaser shall be given an opportunity to exercise a right of first refusal of the best bona fide offer for the gas. If the right of first refusal is not exercised, the first purchaser will transport the gas for the new purchaser under appropriate rates and conditions.

3. Indefinite Price Escalation Clauses - All contracts in effect prior to the effective date of the legislation (except contracts for Section 107 Gas), containing IPE or area rate clauses would be capped at the lower of the contract price or the "market reference price." The market reference price would be determined on the basis of the national weighted average price paid for "new new" gas during the three most recent calendar months for which data are available. The capping mechanism would remain in effect until the contracts containing IPE clauses or area rate clauses are renegotiated or amended.

4. Decontrol - "New new" gas would be gas contracted for on or after the effective date of the legislation and would not be subject to the pricing provisions of Title I of the NGPA. In addition, the date for decontrolling NGPA gas that is subject to decontrol under the NGPA would be moved forward to January 1, 1984.

Through legislative enactment with provision for expedited court review, the certainty would be at hand to better assure a leveling of current market disorders and a smooth transition to the ultimate goal of wellhead price deregulation.

Q. There have been numerous charges that the laws of supply and demand do not operate in the gas market; cited as evidence for this are the continuous increases in gas prices in the face of an apparent surplus of gas.

How do you explain this apparent failure of the laws of supply and demand?

To what extent is the regulatory structure responsible for these results?

A. The theoretical free market, perfectly responsive to the "laws of supply and demand," requires several important conditions, including,

- o low transaction costs, and
- o low information cost.

Several key characteristics of the current gas market place have created market imperfections that violate the conditions necessary for a free market.

These market imperfections arise from several sources. Most importantly, current natural gas market conditions are the legacy of three decades of government intervention in gas supply matters and much longer regulation at the local utility level. In addition, the uncertainties of all energy markets have made it difficult, if not impossible, to develop information about likely future market conditions.

The characteristics just noted have generated market imperfections manifested through problems such as:

- o rigid contract entanglements
- o automatic price increases legislated by the NGPA.

The magnitude of the current contract rigidity problems results from all three sources described earlier. First, the enforcement of wellhead gas price ceilings below market clearing levels produced a predictable competitive response. Because gas pipelines could not compete on the basis of price bids, the competition channelled into non-price bidding. This non-price bidding included offering concessions to suppliers such as various minimum take-or-pay levels or various price escalation clauses. Moreover, because the gas industry had suffered serious supply problems when wellhead price regulation encouraged gas consumption and discouraged gas supply, gas companies responded with aggressive bidding to gain a better supply position to hold customers--just as airlines competed with various non-price offers during the period of heavy commercial airline regulation.

Market uncertainty--resulting from both world energy market uncertainty and uncertainty about how the future regulatory environment might look--also contributed to the contracts problems. Because the success of OPEC during the 1970's led to an exaggerated view of OPEC's strength, purchasers were willing to sign contracts with price escalator clauses that could increase prices but not decrease them. The same expectations that led purchasers to accept these contractual terms must have been shared by regulators because no complaints were raised when the pipelines were lining up gas supplies under such terms.

All these factors led to concessions by gas purchasers that have proven unsuited to today's market conditions. For instance, reasonable minimum take or pay levels were (and are) a prudent feature of supply agreements where a supplier must assure adequate sales of gas to arrange financing and where a purchaser must assure adequate supplies to cover the costs of the link up to his pipeline system. Second, price escalator agreements provided a means of sharing the risks and benefits of future gas values between buyers and sellers. The perverse incentives generated by wellhead price controls knocked these considerations out of balance and into a posture favoring sellers. This has led to contracts with high minimum take levels and irreversible price escalation.

The automatic NGPA price increases and other NGPA provisions also contribute to the inability of the gas market to have a price response to current gas market conditions. When Congress passed the NGPA, it also confronted the same significant uncertainties that the gas industry has faced. The NGPA sought to phase the gas industry into an economic regime approximating a free market. The NGPA has provided a substantial advance over previous policy by (i) eliminating the dual market (intra- vs. interstate), (ii) improving the supply situation, and (iii) establishing wellhead decontrol as a Federal policy goal. Congress planned this transition, however, to a set of market conditions that were obsolete within a year of passage.

The NGPA transition clearly was not a market solution for a number of reasons. It included a complex differentiation system introduced for an otherwise-uniform commodity (the NGPA price categories) and explicit cross-subsidization activities such as the incremental pricing provisions. Moreover, the Fuel Use Act provisions left in effect added added another set of potentially important market constraints.

The current poor performance of the economy has exacerbated gas market problems. At a time when a transition was underway that would have been difficult under any circumstances, the slack demand and load loss occurring because of general economic problems has removed considerable flexibility in pipeline responses to the current supply situation.

B. The answer to the previous sub-question makes it clear that the regulatory structure of the gas industry has played an important part in the generation of the market failure symptoms evident today.

Q. It is noted on page 10 of INGAA's testimony that the "basic cause of gas price increases is the change in mix of gas supplies under the NGPA."

To what extent then, would the various proposals currently pending before the Committee*/ reduce or moderate the increase in residential gas prices if any or all were adopted?

A. INGAA's view that the basic cause of gas price increases is the change in the mix of gas supplies under the NGPA is supported by the recent findings of the General Accounting Office (GAO) cited in response to another question. GAO's analysis suggests that a primary cause of gas price increases--the natural decline of old gas priced at below-market levels--would not be addressed by the various proposals pending before the Committee.

Proposals which merely seek to freeze natural gas prices or severely limit take-or-pay obligations cannot halt the natural decline of old low-priced gas. INGAA has not performed a detailed analysis of the extent to which these proposals could reduce or moderate the increases in residential gas prices.1/

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*/ S. 2074; S. 2892; S. 3028; S. 3054; S. 3069; S. 3070; S. 3076; S. 3088.

1/ At the hearings, the Natural Gas Supply Association testified that while average residential gas prices rose by $.95/MMBtu between July 1981 and July 1982, wellhead prices rose by only $.39/MMBtu in the same period. Using this data, wellhead price increases account for 41% of the residential price increase. Since the hearings, the Energy Information Administration has issued updated data (see the December, 1982, Monthly Energy Review) which shows that residential gas prices rose $.86/mcf from August, 1981, to August, 1982, while the national wellhead price rose $.47/mcf. Using the August statistics, wellhead price increases account for 55% of the residential price increase. The Committee should note that month-to-month comparisons of natural gas price increases are inherently problematic due to the seasonal nature of gas use (especially by residences) and the constant revisions in monthly data.

Q. What impact would the various proposals currently pending before the Committee*/ have on:

-- residential, commercial and industrial gas prices?
-- short-term and long-term gas supplies?
-- the financial situation of interstate gas pipelines?

A. INGAA has not performed a detailed analysis of the various proposals currently pending before the Committee. However, we are deeply concerned about the potential negative impact of a gas price freeze on long-term gas supplies. INGAA's testimony before the Committee cited government statistics to show that the long-term supply situation, which was a major factor in persuading Congress to vote for the price increases in the NGPA, has not changed dramatically since the passage of the Act. The Congress should not be lulled into a false sense of security about future supply by the short-term surplus of deliverability currently being experienced in the gas market. Rather, we should take advantage of the currently soft market to reduce the price rigidities in current contracts and in the NGPA so that prices can go both up and down in response to market conditions.

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*/ S. 2074; S. 2892; S. 3028; S. 3054; S. 3069; S. 3070; S. 3076; S. 3088.

Q. What impact would enactment of the proposals currently pending before the Committee*/ have on the producer/pipeline renegotiations which are currently underway?

A. INGAA is loath to speculate on the potential effects of the proposals currently pending before the Committee on producer/pipeline renegotiations. However, INGAA is persuaded that legislative action on the contracts problem (both on the take-or-pay aspect and on the indefinite price escalator clause problem) will be needed to create a properly functioning gas market where price can go down as well as up. As stated in our testimony, we do not believe that private sector efforts will be sufficient to overcome the contractual legacy of 29 years of wellhead price controls. The sheer volume of renegotiation required and the inherent difficulties involved in achieving substantial changes in contract terms of long standing suggest that even vigorous efforts to address existing contract problems will not be fully successful.

However, INGAA believes that these contract issues should not be addressed separately from the decontrol of new gas contracted for after a date certain or the removal of demand restraints from the gas market.

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*/ S. 2074; S. 2892; S. 3028; S. 3054; S. 3069; S. 3070; S. 3076; S. 3088.

Q. Your statement says that "a major cause of the price increase is the shift in volumes from lower-cost NGPA categories to higher-cost NGPA categories. This shift is predominantly due to the natural decline of old gas." (page 7) Do you have any statistical evidence to substantiate that? Are you sure it is not due to lower takes (due to take or pay provisions) of old gas?

A. The statistical evidence for our statement about the effect of natural decline of old gas comes from the Energy Information Administration (EIA). EIA data show that production of interstate old gas (covered by Sections 104 and 106 of the NGPA) has historically declined by 10 to 11 percent annually. This decline results from normal reservoir development practices and reductions in reservoir pressure.

INGAA's view that the basic cause of gas price increases is the change in the mix of gas supplies under the NGPA is supported by the recent findings of the General Accounting Office (GAO). The GAO performed the following analysis:

> "To provide some perspective on the relative importance of prices and proportions, we compared the actual prices and quantities for 1981 with two alternatives. First, we calculated the average price of buying the 1981 volumes at the 1982 prices, to illustrate the importance of changes in price; the average price went from $2.01 to $2.10. Secondly, we calculated the average price of buying the 1982 volumes at the 1981 prices, to illustrate the importance of changes in proportions; the average price went from $2.01 to $2.22.
>
> The overall increase of $0.34 per Mcf may be compared with the 1981 quantities/1982 prices increase of $0.09 and the 1982 quantities/1981 prices increase of $0.21. The changes in proportionate quantities appear to account for about twice as much of the overall change as the price changes. Even after the seven-percent inflation rate between the two periods is considered, the changes in proportionate quantities appear to account for at least half the overall change."1/

1/ Preliminary Analysis of Natural Gas Price Increases December 9, 1982, GAO, p. 11.

You ask how we can be sure that the decreased production of old gas is due to natural decline rather than lower takes. Lower takes (due to recent take-or-pay problems) would make recent production decline rates appear greater than historical levels. On the contrary, the latest EIA data indicates that interstate old gas production (Section 104/106 gas) was slightly higher in mid-1982 relative to mid-1981 than would be expected, given historical decline rates. Historical decline rates (shown in Table 1 below) have averaged 10 to 11%, while the decline rate between mid-1981 and mid-1982 was only 9%. The EIA data indicate that old gas purchases have necessarily declined in the past and will continue to decline in the future. While individual companies may be constrained by take-or-pay clauses to take lower quantities of old gas, the aggregate statistics suggest that this phenomenon is not happening to a significant degree in the interstate market as a whole.

Table 1

Decline Rates of Interstate Old Gas (Section 104/106)

Years	Decline Rate
1977-1976[1/]	11%
1978-1977[1/]	11%
1979-1978[1/]	10%
1980-1979[1/]	11%
mid-1982/mid-1981[2/]	9%

1/ Current State of the Natural Gas Market, December, 1981, DOE/EIA,

Q. You say (on page 8) that the EIA data "suggest that the highest cost gas does not, on average, have the highest take requirements." You use the word "suggest"--how can we be sure?

A. The data cited was based on two surveys conducted by the Energy Information Administration. The first survey was based on contracts on file at the Federal Energy Regulatory Commission and is described in EIA'S publication entitled Natural Gas Pipeline/Producer Contracts: A Preliminary Analysis, December, 1981. The second survey was based on a statistically selected sample of 400 producers and purchasers of natural gas in late 1981 and is documented in Natural Gas Producer/Purchaser Contracts and Their Potential Impacts on the Natural Gas Market. The advantage of a statistically selected sample is that it allows the analyst to assess contract terms without reading every single contract. Statistical methods can then be used to determine the variability of the take-or-pay value reported based on the way in which the sample was taken. Thus, in EIA's table displaying the results of their survey (displayed below), they show the variation in the reported value (which is generally quite small for this data). Explanatory note "a" is reproduced for the Committee's convenience.

EIA's report describes the results of Table 13 as follows:

> "Table 13 summarizes the average take-or-pay percentages by NGPA section. The highest percentage, 97.8 percent, is for stripper well (Section 108) gas. Section 107, high-cost gas, has the lowest average at 75.8 percent."[1/]

INGAA used the term "suggest" in describing these results because EIA classified any take-or-pay provision which was not related to well deliverability or capacity as if it were a 100 percent of a contract quantity. Since contracts which base the take-or-pay requirement on a percent of the remaining reserves (rather than deliverability) are likely to result in a lower take-or-pay than 100% of deliverability,

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1/ Natural Gas Producer/Purchaser Contracts and Their Potential Impacts on the Natural Gas Market, DOE/EIA, June, 1982, p. 40.

Table 13[1/]
Summary of Take-or-Pay Provisions by NGPA Section and Vintage[a/]

NGPA Section and Vintage	Weighted Average Percent Take Requirement
NGPA Section	
102 Onshore	87.2 (0.03)
102 Offshore	90.4 (0.01)
103	80.1 (0.02)
107	75.8 (0.04)
108	97.8 (0.02)
105/106(b)	75.9 (0.09)
104/106(a)[b/]	92.0 (NA)
Vintage[c/]	
Pre-1973	78.1 (0.08)
1973-April 20, 1977	94.0 (0.03)
April 20, 1977-11/8/78	88.0 (0.02)
November 9, 1978-1979	86.8 (0.02)
1980	79.0 (0.02)

[a/] Coefficients of variation are contained in parenthesis beside value presented; see footnote a, Table 4, for an explanation of these statistics.

[b/] Data on 104 and 106(b) data are not based on the Form EIA-758 data but the study published in December 1981 [2].

[c/] These data on vintage do not include Section 104 and 106(a) data.

NA = Not available.

[a/] (From Table 4) Coefficients of variation are contained in parenthesis beside the values presented. These permit certain confidence statements about the sample estimates. The particular sample used in this survey is one of a large number of samples of the same size that could have been selected using the same design. In about 2 out of 3 (67 percent) of these samples, the estimate would differ from a complete enumeration by less than the corresponding percent (coefficient of variation) for that estimate. In about 19 out of 20 (95 percent) of these samples, the estimate would differ from the results of a complete enumeration by less than twice the percent (coefficient of variation).

[1/] Natural Gas Producer/Purchaser Contracts and Their Potential Impacts on the Natural Gas Market, DOE/EIA, June, 1982, p. 41.

INGAA was concerned that the data for some gas categories (especially the older 104/106 gas where these "reserve life" take requirements were more common) might not be representative. Since reserve life take requirements have been less frequent in recent years, we suspect that this assumption did not distort the analysis of the more recent vintages of gas (Section 102, 103, and 107). However, the assumption may have overstated the take requirements for older gas (especially Sections 104/106).

EIA's survey is the most comprehensive assessment of the contract issue to date. Hence, to the extent that the Committee is willing to rely on sampled data, the EIA survey is the best source of information on this question of which we are aware. Interpretation of the data would be facilitated if EIA were to report separately the results for take-or-pay requirements based on deliverability and take-or-pay requirements not based on deliverability.

Q. The producers oppose doing anything to defuse take or pay requirements, or to freeze prices, saying the industry will work things out. What evidence do you have that contract renegotiations are occurring? Have you surveyed your members to see what's happening? Will you do so?

A. As INGAA stated in its testimony, a number of our companies are aggressively seeking to renegotiate existing gas contracts where the contracts no longer fit market conditions. Based on conversations with our member companies and after reviewing a number of the responses of pipelines to Chairman Sharp's December 3, 1982, request for details of the results of pipeline/producer renegotiations, we know that a number of pipelines are engaged in active discussions with producers. However, INGAA has not separately surveyed its members; and therefore, we do not currently have an overall assessment of the outcome of these negotiations. Based on the responses to Chairman Sharp's letter we have seen to date, pipelines have achieved only a mixed success in their efforts to renegotiate existing contracts. Pipelines have been more successful in negotiating adjustments in take-or-pay requirements than in negotiating changes in price terms. In a limited number of cases, producers have agreed to reduce takes and waive pre-payments by the pipeline. In a substantial number of cases, producers have indicated a willingness to reduce takes but want to negotiate with the pipeline over consideration for the reduction. With respect to price renegotiation, pipelines are continuing to exercise their contractual rights to reduce prices for deregulated gas. However, pipelines efforts to reduce prices where the contract does not have a market out or to change the pricing provisions of the contract upon decontrol of the gas have met with considerable resistance. Finally, a number of pipelines have sponsored meetings between their customers and their suppliers to facilitate communication up and down the pipe about end-use market conditions. We look forward to reviewing the complete responses to Chairman Sharp's letter. These responses may provide the basis for a more complete answer to your question. However, notwithstanding our hopes for the success of these renegotiations we believe that the contract problems common to the industry can be diffused in a more timely and uniform fashion through legislative action.

Q. There have been numerous charges that the laws of supply and demand do not operate in the gas market; cited as evidence for this are the continuous increases in gas prices in the face of an apparent surplus of gas.

How do you explain this apparent failure of the laws of supply and demand?

To what extent is the regulatory structure responsible for these results?

A. The theoretical free market, perfectly responsive to the "laws of supply and demand," requires several important conditions, including,

- o low transaction costs, and
- o low information cost.

Several key characteristics of the current gas market place have created market imperfections that violate the conditions necessary for a free market.

These market imperfections arise from several sources. Most importantly, current natural gas market conditions are the legacy of three decades of government intervention in gas supply matters and much longer regulation at the local utility level. In addition, the uncertainties of all energy markets have made it difficult, if not impossible, to develop information about likely future market conditions.

The characteristics just noted have generated market imperfections manifested through problems such as:

- o rigid contract entanglements
- o automatic price increases legislated by the NGPA.

The magnitude of the current contract rigidity problems results from all the sources described earlier. First, the enforcement of wellhead gas price ceilings below market clearing levels produced a predictable competitive response. Because gas pipelines could not compete on the basis of price bids, the competition channelled into non-price bidding. This non-price bidding included offering concessions to suppliers such as various minimum take-or-pay levels or various price escalation clauses. Moreover, because the gas industry had suffered serious supply problems when wellhead price regulation encouraged gas consumption and discouraged gas supply, gas companies responded with aggressive bidding to gain a better supply position to hold customers--just as airlines competed with various non-price offers during the period of heavy commercial airline regulation.

Market uncertainty--resulting from both world energy market uncertainty and uncertainty about how the future regulatory environment might look--also contributed to the contracts problems. Because the success of OPEC during the 1970's led to an exaggerated view of OPEC's strength, purchasers were willing to sign contracts with price escalator clauses that could increase prices but not decrease them. The same expectations that led purchasers to accept these contractual terms must have been shared by regulators because no complaints were raised when the pipelines were lining up gas supplies under such terms.

All these factors led to concessions by gas purchasers that have proven unsuited to today's market conditions. For instance, reasonable minimum take or pay levels were (and are) a prudent feature of supply agreements where a supplier must assure adequate sales of gas to arrange financing and where a purchaser must assure adequate supplies to cover the costs of the link up to his pipeline system. Second, price escalator agreements provided a means of sharing the risks and benefits of future gas values between buyers and sellers. The perverse incentives generated by wellhead price controls knocked these considerations out of balance and into a posture favoring sellers. This has led to contracts with high minimum take levels and irreversible price escalation.

The automatic NGPA price increases and other NGPA provisions also contribute to the inability of the gas market to have a price response to current gas market conditions. When Congress passed the NGPA, it also confronted the same significant uncertainties that the gas industry has faced. The NGPA sought to phase the gas industry into an economic regime approximating a free market. The NGPA has provided a substantial advance over previous policy by (i) eliminating the dual market (intra- vs. interstate), (ii) improving the supply situation, and (iii) establishing wellhead decontrol as a Federal policy goal. Congress planned this transition, however, to a set of market conditions that were obsolete within a year of passage.

The NGPA transition clearly was not a market solution for a number of reasons. It included a complex differentiation system introduced for an otherwise-uniform commodity (the NGPA price categories) and explicit cross-subsidization activities such as the incremental pricing provisions. Moreover, the Fuel Use Act provisions left in effect added another set of potentially important market constraints.

The current poor performance of the economy has exacerbated gas market problems. At a time when a transition was underway that would have been difficult under any circumstances, the slack demand and load loss occurring because of general economic problems has removed considerable flexibility in pipeline responses to the current supply situation.

The answer to the first sub-question makes it clear that the regulatory structure of the gas industry has played an important part in the generation of the market failure symptoms evident today.

JAMES A. MC CLURE, IDAHO, CHAIRMAN
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United States Senate
COMMITTEE ON
ENERGY AND NATURAL RESOURCES
WASHINGTON, D.C. 20510

January 3, 1983

Mr. J. L. Terrill and
Mr. Stan McLelland
℅ Katherine Edwards
Baker and Botts
1701 Pennsylvania Avenue, N.W.
Suite 300
Washington, D.C. 20006

Dear Mr. Terrill and Mr. McLelland:

Attached are questions in follow-up to your appearance at the Committee's December 13, 1982 hearing on current conditions in the natural gas market. Please provide your responses to these questions to the Committee not later than the close of business January 17, 1983. If any clarification is needed you may contact Mr. Howard Useem (202-224-5205) of the Committee staff.

Sincerely,

James A. McClure

James A. McClure
Chairman

Enclosures

JAM:HU

QUESTIONS FROM REPUBLICAN MEMBERS OF THE COMMITTEE

1. It is noted on page 8 of the Coalition of Intrastate Pipelines' testimony that the problems with the NGPA warrent its revision.

   Q. In your opinion, do any of the proposals currently pending before the Committee*/ address these problems? What other recommendations for legislative changes would you make?

2. In your opinion, to what extent would the various proposals currently pending before the Committee reduce or moderate the increases in residential gas prices if any or all were adopted?

3. In the Coalition's opinion, what impact would the various proposals currently pending before the Committee have on:

   --residential, commercial and industrial gas prices?
   --short-term and long-term gas supplies?
   --the financial situation of producers, pipelines and gas distribution companies?

4. In the Coalition's opinion, to what extent and on what matters does the Federal Energy Regulatory Commission have the statutory authority to take action to address current and potential future problems in the gas market? Please provide the Committee with a detailed legal analysis of the FERC's authority. What actions would you recommend that the FERC take?

5. In your opinion, what impact would the various proposals currently pending before the Committee */ have on intrastate gas supplies, both in the short-term and over the long-term?

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*/ S. 2074, S. 2892; S. 3028; S. 3054; S. 3069; S. 3070; S. 3076; S. 3088.

QUESTIONS FROM DEMOCRATIC MEMBERS OF THE COMMITTEE

QUESTION FOR INTRASTATE PIPELINE COALITION (J.L. TERRILL)

1. How many intrastate pipelines are there?

2. Who are the members of your coalition?

3. Do old intrastate contracts have take or pay provisions in them? (If yes, it's difficult to say they are a direct result of the NGPA if contracts entered into in the "free market" had take or pay provisions.)

4. Do intrastate pipeline contract take or pay provisions resemble interstate ones -- that is, the higher percentages apply to more recent sales?

5. Your statement says (on page 5) that "Under current regulatory procedures, even if expedited by statute, it is extremely unlikely that contracts could be analyzed and modified, resulting in modification to PGA's and surcharge adjustments, in time to offer relief in January and February when it will be needed the most." Could you explain that in greater detail -- why does it take so long?

6. Your chart, showing intrastate natural gas prices prior to the NGPA, is interesting. Do you have the same data for the post-NGPA time period? If so, could you submit it for our record? Could you have both charts footnoted, to show the data sources?

QUESTIONS FROM DEMOCRATIC MEMBERS OF THE COMMITTEE

QUESTION FOR INTRASTATE PIPELINE COALITION (CONTINUED)

7. I'm worried about what effect these "quick fix" bills could have on producers' ability to secure loans. Have you talked to any bankers about these bills? What do they say?

JAN 1 8 1983

Official Committee File

January 17, 1983

SENATE COMMITTEE ON
ENERGY AND NATURAL RESOURCES
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WASHINGTON, D.C. 20510

The Honorable James A. McClure
United States Senate
3121 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator McClure:

Attached is our response to the questions presented in your letter of January 3, 1983 to Mr. J. L. Terrill and Mr. Stan McLelland on behalf of the Coalition of Intrastate Pipelines.

If we can be of any further assistance to the Committee, please do not hesitate to contact us.

Sincerely,

J. L. Terrill

J. L. Terrill
Louisiana Intrastate Gas Corp.

Stan McLelland

Stan McLelland
Valero Transmission Company

Attachment

QUESTIONS FROM REPUBLICAN MEMBERS OF THE COMMITTEE

1. It is noted on page 8 of the Coalition of Intrastate Pipelines' testimony that the problems with the NGPA warrant its revision.

Q. In your opinion, do any of the proposals currently pending before the Committee address these problems? What other recommendations for legislative changes would you make?

All of the proposals you mention address some but not all of the problems. A comprehensive solution, such as proposed by Senator Johnston in S.2074, offers the best approach.

2. In your opinion, to what extent would the various proposals currently pending before the Committee reduce or moderate the increases in residential gas prices if any or all were adopted?

Please see response to question 3.

3. In the Coalition's opinion, what impact would the various proposals currently pending before the Committee have on:

-residential, commercial and industrial gas prices?
-short-term and long-term gas supplies?
-the financial situation of producers, pipelines and gas distribution companies?

Any piecemeal solution, such as a freeze or a change in some contractual provision, is not likely to address adequately all of the structural defects in the gas market which are responsible for the disorders which currently prevail, but could drastically affect the financial situation of one or more segments of the industry. For example, a price freeze which would stop NGPA maximum lawful price escalation might result in lower prices, but would not necessarily do so since a pipeline's supply is composed of various sources at different prices, as well as fixed costs. Thus, a pipeline's price to its customers may change due to alterations in its mix. A freeze would not alter this. In addition, a freeze might operate, depending on contract terms, to artificially prop prices up at levels higher than they might otherwise be.

A comprehensive solution, such as proposed by Senator Johnston, offers the best approach.

4. In the Coalition's opinion, to what extent and on what matters does the Federal Energy Regulatory Commission have the statutory authority to take action to address current and potential future problems in the gas market? Please provide the Committee with a detailed legal analysis of the FERC's authority. What actions would you recommend that the FERC take?

Since, as intrastate pipelines, we are involved with FERC jurisdiction only on limited occasions, we have not formed an opinion on the extent of FERC's statutory authority to address problems in the gas market. Some of the members of the Coalition have responded to this issue in other proceedings. 1/

5. In your opinion, what impact would the various proposals currently pending before the Committee have on intrastate gas supplies, both in the short-term and over the long-term?

Proposals for a piecemeal solution do not address the basic cause of the market disorders which affect both intra- and interstate pipelines. That basic cause is the

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1/ See FERC Notice of Inquiry Comments, filed by Houston Pipe Line Company and Valero Transmission Company (RM82-26), August 26, 1982.

artificial bidding disparities occasioned by the many different pricing and allocation categories, sometimes referred to as the "cushion" problem. Thus, the intrastate supply and price situation is not likely to be placed on equal footing. Again, a comprehensive solution, such as Senator Johnston has proposed, should help both interstate and intrastate pipelines.

QUESTIONS FROM DEMOCRATIC MEMBERS OF THE COMMITTEE

1. How many intrastate pipelines are there?

According to the EIA, there are intrastate pipelines operating in twenty-four states. 1/ Of these, Texas and Louisiana together represent approximately 70% of the entire intrastate market.

According to the State Commissions regulating intrastate transactions in these states, there are approximately 48 intrastates in Louisiana of which five carry approximately 80% of the load. There are 244 intrastate pipelines in Texas of which four carry most of the load.

2. Who are the members of your coalition?

The members of the Coalition of Intrastate Pipelines are Houston Pipe Line Company, Louisiana Intrastate Gas Corporation (LIG), Southwestern Gas Pipeline, Inc., Valero Transmission Corporation and Louisiana Resources Company (LRC). According to Foster Associates' June 1980 study on the impact of the NGPA on intrastate markets in Louisiana, prepared for the Louisiana Office of Conservation, LIG and LRC represent over 50% of the sales by independent non-affiliated intrastate pipelines. In Texas, the remaining three companies represent approximately 40% of the total

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1/ Department of Energy, Energy Information Administration, Intrastate and Interstate Supply Market Under the Natural Gas Policy Act, October, 1981, at 9.

intrastate throughput with Houston Pipe Line and Valero the two largest intrastate pipelines in the state. 2/

3. Do old intrastate contracts have take-or-pay provisions in them? (If yes, it's difficult to say they are a direct result of the NGPA if contracts entered into in the "free market" had take-or-pay provisions.)

As we pointed out in our testimony, take-or-pay clauses are found in intrastate contracts and in interstate contracts before and after the NGPA. 3/

We do not believe that the issue raised is whether the NGPA caused take-or-pay clauses. The issue is what effect the NGPA has had on the level of take-or-pay for some pipelines. To illustrate, since the NGPA sets ceiling prices, all pipelines are equally limited in their maximum current price bid, so the negotiations are shifted to bidding on the basis of, *inter alia*, take-or-pay levels, economic protection, and on pricing clauses after deregulation. Pipelines with a cushion of price controlled gas and FERC approved rate base treatment of payments made under take-or-pay clauses can offer better terms such as higher take-or-pay levels and better deregulated pricing clauses. That is the point. We would like to emphasize, however, that take-or-pay is only one of a host of problems resulting from market distortions created by the NGPA.

4. Do intrastate pipeline contract take-or-pay provisions resemble interstate ones--that is, the higher percentages apply to more recent sales?

2/ Energy Planning Associates, The Texas Natural Gas Industry Outlook to 1990, Vol II, Chapter 6. (1982).

3/ 18 C.F.R. § 154.103.

We do not have information to confirm the premise of this question, nor to generalize an answer to this question.

5. Your statement says (on page 5) that "Under current regulatory procedures, even if expedited by a statute, it is extremely unlikely that contracts could be analyzed and modified, resulting in modification to PGA's and surcharge adjustments, in time to offer relief in January and February when it will be needed the most." Could you explain that in greater detail--why does it take so long?

Under the present regulatory scheme, as we understand it, the interstate pipelines collect rates based on general rate increases which are in various stages of finality, based on PGA filings, which are changed either annually or semi-annually, and based on special rate filings. Even under the fastest possible time frame, it is unrealistic to think that each pipeline could revise their purchasing plans in the light of legislation enacted in December, 1982, prepare appropriate rate filings and lodge them with the FERC, which then must notice the filings and give preliminary consideration, secure whatever preliminary approvals the FERC may give after public comment, and have the new rates in effect by January or February, 1983.

6. Your chart, showing intrastate natural gas prices prior to the NGPA, is interesting. Do you have the same data for the post-NGPA time period? If so, could you submit it for our record? Could you have both charts footnoted, to show the data sources?

There are no data available for the post-NGPA time period similar to those which were collected by the Commission on FPC Form 45 between 1975 and 1978 on intrastate contract prices. That is the data source.

7. I am worried about what effect these "quick fix" bills could have on producers' ability to secure loans. Have you talked to any bankers about these bills? What do they say?

We have not contacted any bankers with respect to the pending proposals.

JAMES A. MC CLURE, IDAHO, CHAIRMAN
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United States Senate
COMMITTEE ON
ENERGY AND NATURAL RESOURCES
WASHINGTON, D.C. 20510

January 3, 1983

Mr. George H. Lawrence
American Gas Association
1515 Wilson Boulevard
Arlington, Virginia 22209

Dear Mr. Lawrence:

Attached are questions in follow-up to your appearance at the Committee's December 13, 1982 hearing on current conditions in the natural gas market. Please provide your responses to these questions to the Committee not later than the close of business January 17, 1983. If any clarification is needed you may contact Mr. Howard Useem (202-224-5205) of the Committee staff.

Sincerely,

James A. McClure

James A. McClure
Chairman

Enclosures

JAM:HU

QUESTIONS FROM REPUBLICAN MEMBERS OF THE COMMITTEE

1. The American Gas Association's testimony refers to "unreasonable" take-or-pay provisions in producer/pipeline contracts.

   Q. Please explain why AGA considers some, presumably high percentage, take-or-pays as "unreasonable"? Isn't it true that contracts with provisions such as these were entered into openly and freely by both the pipeline and the producer?

   Q. In AGA's opinion, if the use of take-or-pays were limited or eliminated altogether, wouldn't producers just demand a higher price for their gas at the wellhead? If this were to occur, wouldn't the savings from limiting the use of take-or-pays just be offset by higher wellhead prices?

2. The AGA's testimony indicates that pipelines have begun to exercise their market out clauses in existing contracts, and are now signing contracts which have much less severe take-or-pay levels, and perhaps more importantly are also signing contracts which set the price of gas below the legal maximum.

   Q. Wouldn't this suggest that Congress closely examine what is going on in the gas market to ascertain the extent of any problems that are occuring and the degree to which normal market forces and industry actions will ameleorate these problems before we attempt to legislate a "fix"?

3. The AGA states on p. 3 of its testimony, that it does not believe that proposals to freeze wellhead prices would help consumers this heating season.

   Q. Please explain the basis for that conclusion.

4. In AGA's opinion, to what extent and on what matters does the Federal Energy Regulatory Commission have the statutory authority to take action to address current and potential future problems in the gas market? Please provide the Committee with a detailed legal analysis of the FERC's authority. What actions would you recommend that the FERC take?

5. In AGA's opinion what impact would the various proposals currently pending before the Committee*/ have on:

   --residential, commercial and industrial gas prices?
   --short-term and long-term gas supplies?
   --the financial situation of producers, pipelines and gas distribution companies?

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*/ S.2074; S. 2892; S. 3028; S. 3054; S. 3069; S. 3070; S. 3076; S. 3088.

QUESTIONS FROM DEMOCRATIC MEMBERS OF THE COMMITTEE

QUESTIONS FOR AGA (BUD LAWRENCE)

1. Your statement says (on page 2) that "(m)inimum takes for new gas are generally higher than the minimum takes for old gas...".

INGAA's statement disagrees. It says that the EIA data "suggest that the highest cost gas does not, on average, have the highest take requirements."

Who's right? How do we know? Could you get together with INGAA and with the producers and see if you can clear that discrepancy up for the record?

2. Your statement says (on page 2) that a "legislative solution is probably necessary" to the contract problem.

When will we know if it's necessary?
How can we tell what kind of renegotiation is going on?
Have you surveyed your members to see what's happening?

3. Your statement says (on page 7) that "Sound legislation should focus on the problem of take or pay and indefinite escalator clauses in pipeline/producer contracts. That legislation should be equitable for all parties." You oppose the Eagleton, Kassebaum, and Specter bills. What do you support?

AGA American Gas Association

1515 Wilson Boulevard, Arlington, Va. 22209
Telephone (703) 841-8400

George H. Lawrence
President

Official Committee File

January 17, 1983

SENATE COMMITTEE ON
ENERGY AND NATURAL RESOURCES
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JAN 18 1983
WASHINGTON, D.C. 20510

Honorable James A. McClure
Chairman
Committee on Energy and
Natural Resources
U.S. Senate
Room 3106
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman McClure:

We are pleased to respond to your questions regarding our December 13, 1982 testimony on current conditions in the natural gas market.

Question 1.

THE AMERICAN GAS ASSOCIATION'S TESTIMONY REFERS TO "UNREASONABLE" TAKE-OR-PAY PROVISIONS IN PRODUCER/PIPELINE CONTRACTS.

Q. Please explain why AGA considers some, presumably high percentage, take-or-pays as "unreasonable"? Isn't it true that contracts with provisions such as these were entered into openly and freely by both the pipeline and the producer?

Take-or-pay clauses that cause pipelines to take higher priced gas, while turning back cheaper gas, are unreasonable from the consumers' viewpoint. Contracts with very high take-or-pay clauses were indeed negotiated between buyers and sellers but reasonable minds could differ on the extent of the free market at work during this period. These contracts date from the days of shortages and curtailments in the late '70s, when producers had enormous bargaining power. Incidentally, we believe that those shortages were induced by the preceding 28 years of Federal price controls and market distortions. Furthermore, since the NGPA still sets the price of new gas, the parties can only bargain over non-price contract terms. In the rush to sign-up new supplies, producers often demanded very favorable non-price terms, such as unprecedented high minimum take requirements. Now that gas supplies are no longer short, and pipelines and producers are on a more equal footing, we see that the most recent contracts have less onerous minimum take requirements. Existing contracts with 80% or even 90+% minimum takes are still in force and effect, however. These contracts can still force pipelines to turn back cheap gas for expensive gas, thus, gas consumers will continue to demand legislative relief from unreasonable take-or-pay clauses in existing contracts.

Q. In AGA's opinion, if the use of take-or-pays were limited or eliminated altogether, wouldn't producers just demand a higher price for their gas at the wellhead? If this were to occur, wouldn't the savings from limiting the use of take-or-pays just be offset by higher wellhead prices?

First, we do not support eliminating minimum take requirements. We think that limiting the take -- in existing contracts for post-NGPA gas -- to a minimum of 50% for the next three years is far preferable. Second, gas markets will be adjusting to decontrol between now and 1985. During that time, we think that a temporary limit on minimum take requirements will aid an orderly transition to decontrol. The savings from temporarily limiting minimum take requirements would not be offset by higher prices because, in today's more competitive market, pipelines would not accept (and producers could not obtain) a higher price for gas already under contract.

Our industry is experiencing significant load loss to residual oil. Net fuel switching from gas to oil was 515 Bcf (258,000 bbl/day) from 1981 through 1982. Gas utility statistics for the industrial market indicate that sales were 16% lower for the first 11 months of 1982 compared to the same period in 1981. In spite of these grim statistics, gas prices are still expected to rise this year. As we said in our testimony, high take-or-pay clauses are prematurely skewing the supply mix toward new gas. Clearly, existing contracts for 1977-82 gas with takes in the 80+% range are adding fuel to the fire, and we think that Congress should temporarily roll-back the minimum takes. Again, we see it as a necessary step to an orderly transition to decontrol of all new gas on 1-1-85 and a lessening of pressure to reimpose field price controls.

Question 2.

THE AGA'S TESTIMONY INDICATES THAT PIPELINES HAVE BEGUN TO EXERCISE THEIR MARKET OUT CLAUSES IN EXISTING CONTRACTS, AND ARE NOW SIGNING CONTRACTS WHICH HAVE MUCH LESS SEVERE TAKE-OR-PAY LEVELS, AND PERHAPS MORE IMPORTANTLY ARE ALSO SIGNING CONTRACTS WHICH SET THE PRICE OF GAS BELOW THE LEGAL MAXIMUM.

Q. Wouldn't this suggest that Congress closely examine what is going on in the gas market to ascertain the extent of any problems that are occurring and the degree to which normal market forces and industry actions will ameliorate these problems before we attempt to legislate a "fix"?

Yes, certainly. For that reason we questioned the wisdom of piecemeal legislation in the lameduck. We also believe that future gas contracts will reflect the market more accurately. Our greatest concern is existing contracts signed during the gas shortages of the mid-1970s and the early years after the NGPA. Our analyses shows that these contracts: (a) generally have no immediately exercisable market-out; (b) generally have take-or-pay clauses above 80+% of deliverability; and (c) generally have indefinite price escalators. The combined effect of these existing contract clauses pushes gas prices above competitive levels.

Question 3.

THE AGA STATES ON P. 3 OF ITS TESTIMONY, THAT IT DOES NOT BELIEVE THAT PROPOSALS TO FREEZE WELLHEAD PRICES WOULD HELP CONSUMERS THIS HEATING SEASON.

Q. Please explain the basis for that conclusion.

Because pipeline customers' are now being billed under Purchase Gas Adjustment filings made before this heating season, a freeze on wellhead prices now would not affect pipeline customers' bills immediately.

If a freeze lowered wellhead prices so that the PGA filing overcollected, the excess payments would be escrowed and used to offset the pipeline's next purchase gas adjustment filing. Since PGA's are filed every 6 months, it is unlikely that there would be an effect on customers' bills until the next filing, after the heating season.

In addition, most of the price increase this winter derives from changes in the supply mix -- shifting away from old gas and toward new replacement supplies -- and not primarily from price ceiling increases. Therefore, freezing the price ceilings will have only a small effect on average prices.

Question 4.

IN AGA's OPINION, TO WHAT EXTENT AND ON WHAT MATTERS DOES THE FEDERAL ENERGY REGULATORY COMMISSION HAVE THE STATUTORY AUTHORITY TO TAKE ACTION TO ADDRESS CURRENT AND POTENTIAL FUTURE PROBLEMS IN THE GAS MARKET? PLEASE PROVIDE THE COMMITTEE WITH A DETAILED LEGAL ANALYSIS OF THE FERC'S AUTHORITY. WHAT ACTIONS WOULD YOU RECOMMEND THAT THE FERC TAKE?

Although we have encouraged the Federal Energy Regulatory Commission to use its current legal power, FERC's authority to alter existing contracts for new gas is quite limited. AGA interprets the interaction of the NGPA Section 601 and the Natural Gas Act (NGA) thusly:

- Producer Sales. The FERC has no residual NGA authority over the production or sale of intrastate gas or new gas (except new gas within §§102(d), 107(c)(5), 108 and 109).

- Pipeline Purchases. The FERC cannot use NGA §§4 and 5 to control the amount paid for such natural gas because such amounts paid are legislatively deemed just and reasonable.

- Pipeline Certificates. The FERC cannot deny or make conditional NGA §7 certificates of public convenience and necessity on the grounds of amount paid if such amount is deemed just and reasonable.

- Pipeline Sales. The FERC cannot deny pipeline recovery of the amount paid if such amount is deemed just and reasonable, which is further defined in the Act as the absence of fraud, abuse, or similar grounds.

Thus, FERC has no authority to regulate post-NGPA contracts, unless there is fraud, abuse, or similar grounds. The recent decision of the Administrative Law Judge in the widely reported Columbia Gas Transmission case (Docket No. TA81-1-21-0001) notwithstanding, the Commission said in its Policy Statement of February 4, 1982, that the NGA "prudence" standard does not apply to NGPA Section 601(c). There has to be "fraud" , or actual misrepresentation, to prove "abuse or similar grounds".

The Commission has, however, done two things that affect natural gas contracts. Last December it issued a policy statement on take-or-pay clauses that put pipelines on notice that prepayments -- under future contracts with minimum takes above 75% of annual deliverability -- can not be recovered in the pipeline's rate base. A regulatory analysis of this Policy Statement is attached. Furthermore, on October 1, 1982[1] the Commission ruled that although it would not consider the prudence of a pipeline's gas purchases in a Purchase Gas Adjustment hearing under NGPA Section 601, the Commission may consider the prudence, or imprudence, of gas purchases in NGA Section 4 and 5 rate cases.

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[1] Order Denying Rehearing in Tennessee Gas Pipeline Company Unconsolidated Docket Nos. TA82-2-9-000, RP81-54-000, RP82-12-001, TA82-1-9-001.

Question 5.

IN AGA'S OPINION WHAT IMPACT WOULD THE VARIOUS PROPOSALS CURRENTLY PENDING BEFORE THE COMMITTEE[2] HAVE ON:

-- residential, commercial and industrial gas prices
-- short-term and long-term gas supplies?
-- the financial situation of producers, pipelines and gas distribution companies?

Unfortunately, the quantity and diversity of gas pricing bills before Congress during the last session precluded an indepth analysis of the price, supply, and financial effects of individual bills. To the extent that any of the bills proposed short-term wellhead price freezes, however, we believe that the bills would not bring prices down quickly, for the reasons given in #3 above. We also believe that any bill that delays or prevents scheduled decontrol in 1985 would disrupt the drilling industry and suppress gas supplies and be wholly contrary to a sound national energy policy.

QUESTIONS FROM DEMOCRATIC MEMBERS OF THE COMMITTEE

Question 1.

YOUR STATEMENT SAYS (ON PAGE 2) THAT "(M)INIMUM TAKES FOR NEW GAS ARE GENERALLY HIGHER THAN THE MINIMUM TAKES FOR OLD GAS. . .".

> INGAA'S STATEMENT DISAGREES. IT SAYS THAT THE EIA DATA "SUGGEST THAT THE HIGHEST COST GAS DOES NOT, ON AVERAGE, HAVE THE HIGHEST TAKE REQUIREMENTS."

Who's right? How do we know? Could you get together with INGAA and with the producers and see if you can clear that discrepancy up for the record?

Both of us are right. INGAA's statement is correct -- the highest cost gas, that is §107 deregulated gas, does not on average have the highest minimum takes. EIA's study on Natural Gas Producer/Purchaser Contracts and Their Potential Impacts on the Natural Gas Market (June 1982, Table 13, p. 41) shows that Section 107 gas had an average minimum take of 75.8% of deliverability. The same table shows that pre-1973 old gas has weighted average takes of 76.1%, far below the 86.8% take requirements for newer gas contracts between 1977 and 1980. Thus, our statement is also correct -- the minimum takes for post 1973 gas are generally higher than the minimum takes for old gas. The EIA data also tends to show that minimum take requirements are slowly declining and thus supports our position that only existing contracts should be rolled back. (It should be noted that EIA Table 13 indicates that old interstate gas contracts have take requirements of 92% and cites the reader to a previous EIA study. As explained to us by EIA, the 92% estimate was taken from a separate FERC study and is not comparable to the other EIA data because the 92% refers to a percentage of reserves while the other data are based on percentages of deliverability.

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[2] S. 2074; S. 2892; S. 3028; S. 3054; S. 3069; S. 3070; S. 3076; S. 3088.

Question 2.

YOUR STATEMENT SAYS (ON PAGE 2) THAT A "LEGISLATIVE SOLUTION IS PROBABLY NECESSARY" TO THE CONTRACT PROBLEM.

WHEN WILL WE KNOW IF IT'S NECESSARY?
HOW CAN WE TELL WHAT KIND OF RENEGOTIATION IS GOING ON?
HAVE YOU SURVEYED YOUR MEMBERS TO SEE WHAT'S HAPPENING?

A legislative solution to the contracts problem is necessary, in part because no one can predict whether efforts to renegotiate existing contracts will succeed. We have anecdotal evidence that some recent contracts have been signed for gas below ceiling prices or have less onerous terms, and in some cases, have both lower prices and easier terms. Still, we are not aware of any existing new gas contract renegotiations that have come to fruitition even though producers have approximately 1.9 to 2.7 Tcf shut-in gas this year. We have informally surveyed our members on their contract renegotiations, but we have no indication that their efforts will be successful enough to change the status quo.

Question 3.

YOUR STATEMENT SAYS (ON PAGE 7) THAT "SOUND LEGISLATION SHOULD FOCUS ON THE PROBLEM OF TAKE OR PAY AND INDEFINITE ESCALATOR CLAUSES IN PIPELINE/PRODUCER CONTRACTS. THAT LEGISLATION SHOULD BE EQUITABLE FOR ALL PARTIES". YOU OPPOSE THE EAGLETON, KASSEBAUM, AND SPECTER BILLS. WHAT DO YOU SUPPORT?

We could not support a bill that decontrols old gas or recontrols new gas. We believe that title I of NGPA should not be reopened. Instead, Congress should deal with the major gas contracts problems: indefinite escalators and high take-or-pay requirements. We support rolling back the takes on existing contracts for post NGPA gas -- to 50% of deliverability -- for three years or until renegotiation. Further, we support a cap on indefinite escalator clauses in existing contracts for 1977-83 vintage gas. Such a "cap" would rise or fall reflecting current market conditions.

Thank you once again for the opportunity to give our industry's view on current conditions in the natural gas market. After 28 years of Federal price controls, our industry is just starting to enter a free market. Naturally, there are problems with contracts signed during the period of transition -- and the transition problems are worsened by the current recession and drop in demand -- but if we solve them, the future for gas energy is bright. Last year we saw reserve additions surpass production for the first time since 1968. Now is the time to remove restraints on industrial gas demand such as incremental pricing and the Fuel Use Act. If Congress addresses demand restraint and contracts problems this year, we believe that all of us -- consumers, utilities, pipelines, and producers -- will benefit.

Sincerely

Bud Lawrence

George H. Lawrence

GHL/lgs

Regulatory Analysis

AGA
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Association

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12/29/82 FERC's POLICY STATEMENT ON PIPELINE RATE
1982-4R BASING OF TAKE-OR-PAY PREPAYMENTS

The Federal Energy Regulatory Commission (FERC) has issued a Policy Statement on the ability of interstate pipelines to include in the rate base certain prepayments made to meet take-or-pay obligations. ("Prepayments" refers to payments for gas that is paid for but not yet taken.)

The Policy Statement appears on pages 57268-57270 of the December 23, 1982 Federal Register. The Statement includes: a) the text of new regulations (18 CFR §2.103); and b) explanatory comments by the Commission.

The New FERC Policy

- Summary: With respect to certain gas purchase contracts (see below), FERC will adopt a "rebuttable presumption" that prepayments cannot be included in an interstate pipeline's rate base "if the prepayments are made pursuant to take or pay requirements . . . which exceed 75 percent of annual deliverability" (18 CFR §2.103(b); page 57270, first column).

- Meaning of "Rebuttable Presumption": The new restriction will automatically apply unless a pipeline can affirmatively persuade FERC that the restriction should not apply. This approach "does not have the force and effect of law"; it is instead "an articulation of the Commission's tentative intentions which will be followed unless circumstances demonstrate the policy to be inappropriate" (page 57268, second column). "In particular cases", FERC recognizes that "both the underlying policy and its application to particular facts may be challenged" (Ibid).

- Contracts Affected: The policy applies only to prepayments under an interstate market contract which is "entered into on or after December 23, 1982" (18 CFR §2.103(b); page 57270, first column). This limited coverage makes the immediate impact of the new policy rather nominal, since it is rare for a newly negotiated contract to contain a "minimum take" of more than 75% of deliverability.

- Rationale: The text of the new regulations begins with the statement that FERC is "Recognizing that take or pay obligations may be shielding the prices of deregulated and other high cost gas from market constraints" (18 CFR §2.103(a); page 57269, third column; emphasis supplied). In its explanatory comments, FERC: 1) notes that "wholesale gas prices have only slowly and reluctantly responded to the decreased demand" (page 57268, second column); 2) emphasizes that "the pricing provisions of conventional gas purchase contracts do not permit downward pricing flexibility" (page 57268, third column); and 3) cites take or pay obligations as a contributing factor, since they "can also be expected to aggravate counter-market behavior by influencing pipelines to take and sell high cost gas while cutting back takes of lower cost gas" (Ibid).

- Notable Ambiguities: Th new 18 CFR §2.103(b) refers to denial of rate base treatment when prepayments are made under "take or pay requirements . . . which exceed 75 percent of annual deliverability".

  a) "Annual deliverability" is not defined. In the absence of a specific reference to open flow deliverability or some alternative measurement, the Commission is presumably referring to "deliverability" as it is defined in the specific contract(s) affected.

  b) The Commission refers to prepayments made "pursuant to" take or pay requirements which exceed 75% of deliverability. Does this mean that rate basing is denied to the extent that prepayments are made for gas volumes in excess of 75% of deliverability? Or does it mean that rate basing is denied for all prepayments if a contract's "minimum take" exceeds 75% of deliverability? The Commission's language is not clear on this point. However, the former interpretation seems more viable in light of FERC's comment that it "has attempted to balance the need for pipeline flexibility in responding to changing market conditions against the need to assure a cash flow to producers to cover their costs" (page 57269, first column). Adoption of the latter interpretation might operate to terminate producer cash flow totally in cases involving "minimum takes" above 75% of annual deliverability.

Other Policies Under Consideration by FERC

FERC notes that its new policy is accompanied by a recent decision -- in a Tennessee Gas Pipeline Company passthrough case (Docket Nos. TA82-2-900 et al.) -- that "a pipeline's purchasing practices should be considered an issue in a general rate case" (page 57268, third column). FERC stresses that "at this time, the Commission is taking only those actions . . . which are clearly within our authority" (page 57269, second column; emphasis supplied). Nevertheless, "the Commission will continue to review the extent of its other authority, if any, to deal with excessive take or pay payments under existing contracts" (page 57268, first column).

FERC mentions three specific possibilities for future action:

- Pipeline Passthrough: FERC will consider arguments that it should reinterpret §601(c)(2) of the Natural Gas Policy Act, classify certain take or pay obligations as an "abuse", and deny pipeline passthrough of costs incurred under such contractual obligations. (Page 57269, first column.)

- Direct Regulation of Take or Pay Clauses: FERC will consider arguments that it should adopt a broad reading of Sections 4,5 and 7 of the Natural Gas Act in order "to override or limit the operation of contract terms if the Commission finds the terms to be contrary to the public interest" (page 57269, second column).

- General Treatment of Pipeline Take or Pay Prepayments: FERC indicates that it "is also considering the propriety of revising its current procedures concerning pipeline treatment of prepayments generally" (page 57269, second column). Noting that current rate basing policy permits interstate pipelines "a return and associated taxes" on take or pay prepayments, FERC speculates that the status quo "may be more expensive to consumers than if prepayments were financed through debt arrangements and pipelines were permitted to recover debt costs" (page 57269, third column). While recognizing that "regulatory lag and timing differences" might pose problems, FERC also states flatly that "We intend to pursue this option" (Ibid).

Although FERC's Policy Statement raises the possibilities noted above, the Commission stresses that it "has not come to any final conclusions as to whether it has authority to modify the operation of existing take or pay provisions or to affect the passthrough of costs associated with these contract provisions" (page 57269, second column). In addition, "the Commission has not determined whether any action would be appropriate, assuming such authority exists" (Ibid).

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Legislative and Regulatory Affairs
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December 29, 1982

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United States Senate
COMMITTEE ON
ENERGY AND NATURAL RESOURCES
WASHINGTON, D.C. 20510

January 3, 1983

Mr. Danny Conklin
Independent Petroleum
Association of America
1101 Sixteenth Street, N.W.
Washington, D.C. 20036

Dear Mr. Conklin:

Attached are questions in follow-up to your appearance at the Committee's December 13, 1982 hearing on current conditions in the natural gas market. Please provide your responses to these questions to the Committee not later than the close of business January 17, 1983. If any clarification is needed you may contact Mr. Howard Useem (202-224-5205) of the Committee staff.

Sincerely,

James A. McClure

James A. McClure
Chairman

Enclosures

JAM:HU

QUESTIONS FROM REPUBLICAN MEMBERS OF THE COMMITTEE

1. In the Independent Petroleum Association of America's opinion, what impact would the various proposals currently pending before the Committee[*] have on:

   --residential, commercial and industrial gas prices?
   --short-term and long-term gas supplies?
   --the financial situation of producers, pipelines and gas distribution cpmpanies?

2. In IPAA's opinion, to what extent and on what matters does the Federal Energy Regulatory Commission have the statutory authority to take action to address current and potential future problems in the gas market? Please provide the Committee with a detailed legal analysis of the FERC's authority. What actions would you recommend that the FERC take?

3. Your testimony notes that the IPAA represents about 8,000 independent gas producers. What would be the financial impact on the members of your association from a two-year freeze of wellhead prices with a rollback to August 31, 1982 price levels?

4. To what extent would a price freeze affect the exploration and production operations of your members?

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[*] S. 2074; S. 2892; S. 3026; S. 3054; S. 3069; S. 3070; S. 3076; S. 3088.

QUESTIONS FROM DEMOCRATIC MEMBERS OF THE COMMITTEE

QUESTIONS FOR IPAA (DANNY CONKLIN)

1. I'm worried about what effect these "quick fix" bills could have on producers' ability to secure loans. Have you talked to any banks about these bills? What do they say? (You touch on this problem on page 8.)

2. Have any pipelines come to member companies in the IPAA to renegotiate contracts? If so, what has been your response? Have you surveyed your association to see what's happening?

Official Committee File
Please Return

INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA
1101 SIXTEENTH ST., N.W.
WASHINGTON, D.C. 20036
(202) 857-4722

WM. C. ANDERSON
VICE PRESIDENT
POLITICAL AND LEGISLATIVE
RELATIONS

January 14, 1983

SENATE COMMITTEE ON
ENERGY AND NATURAL RESOURCES
RECEIVED
JAN 18 1983
WASHINGTON, D.C. 20510

The Honorable James McClure, Chairman
Senate Energy and Natural Resources Committee
3202 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator McClure:

Enclosed are Danny Conklin's responses to your questions outlined in your January 3 letter.

If you have any further questions, please direct them to us.

Sincerely,

Bill

Wm. C. Anderson

Enclosure

Answers to Questions of the
Senate Energy and Natural Resources Committee

By Danny Conklin, Chairman

Natural Gas Committee

Independent Petroleum Association of America

(Republican Questions)

1. In the Independent Petroleum Association of America's opinion, what impact would the various proposals currently pending before the Committee have on:

--residential, commercial and industrial gas prices?
--short term and long-term gas supplies?
--the financial situation of producers, pipelines and
  gas distribution companies?

There is no single answer to the impact on gas prices to end users. First, natural gas consumers of all categories are served by hundreds of different combinations of producers, pipelines and distributors. Depending on the "mix" of categorical gas going into each system, one gets a completely different result at the burnertip. In addition, the burnertip answer varies depending on the mix of users. Some systems have very few industrial customers, while others have a predominance of such users. Because utility commissioners have treated rates differently for different classes of users, another variable is introduced. In addition, NGPA provides for the incremental pricing of some new gas costs to industrial users. Obviously, this impacts burnertip rates differently depending not only on the mix of gas going into the system, but on the relative ratio of industrial to residential consumers on the system. So the results of the proposals which limit take-or-pay obligations, freeze prices and mandate "cheapest gas input" would vary greatly. Some consumers on some systems may see price drops, or at least a moderation of increases. Yet other consumers may continue to see sharp increases regardless of what one did if industrial load to that system continued to drop due to either the economic slump or fuel substitution -- in the short term. In the longer term, a whole new set of variables come into play. What would be the longer term impact of accelerated depletion of old gas reserves? If there was no market for new, higher cost gas, obviously it wouldn't be produced. Wouldn't this lead to shortages and all the problems that go with those shortages?

As to short-term and long-term supply, the answer again is a variable. Anything which dampens present or prospective incentives will result in reduced drilling and a decline in supplies. During this temporary surplus, such a drop might go unnoticed by most for awhile, but eventually shortages would return. Timetable for a return of shortages would be accelerated by a rapid economic recovery and we could find such shortages actually stifling that much-sought after recovery.

Here again, impacts would vary between systems. For example, a drop in drilling would not immediately impact a "reserve rich" system, but would immediately begin impacting systems which must contract almost daily for new supplies. A drop in new drilling, leading to a drop in new supplies could find those systems forced once again into high cost imports resulting in higher costs to their consumers.

Finally, as producers, we see potential financial disaster for some producers under these proposals. Take-or-pay provisions give producers some regular cash flow assurances. It is out of that cash flow that loans are repaid and other obligations met. Thus, elimination of those provisions, or sharp curtailment, would reduce producer cash flow. In many instances, that reduction would lead to bankruptcy.

In addition, future drilling programs are based on cash flow anticipation. To drastically change that, would mean future programs -- most with signifcant "up front" costs -- would be cancelled resulting in economic waste and loss.

As to the financial impacts on pipelines and distributors, we are not in a position to comment. Certainly, as in any new regulatory scheme, there would be winners and losers, depending on individual situations.

> 2. In IPAA's opinion, to what extent and on what matters does the Federal Energy Regulatory Commission have the statutory authority to take action to address current and potential future problems in the gas market? Please provide the Committee with a detailed legal analysis of the FERC's authority. What actions would you recommend that the FERC take?

No, FERC does not have proper authority to deal with current problems. We have seen over the past 28 years all types of FPC-FERC authority exercised and the results have always been the same -- distortions at both ends of the pipeline. FERC may have the authority to apply a band-aide here or there, but that's not what the natural gas "patient" needs. Major surgery is the only answer and history continues to prove that to us. We believe the only long term solution for FERC authority, is to eliminate it in terms of controlling the price, production and consumption of natural gas.

You ask for a detailed legal opinion of FERC authority. We must ask to be excused from that request. In the first place, such an analysis is beyond the expertise of our Association and to secure such from outside counsel would be costly and too time-consuming to meet your January 17 deadline for reply. In addition, such an analysis would represent nothing more than one more lawyer's opinion on matters that have frequently required the collective wisdom of the U.S. Supreme Court. It seems to us that this question should be directed to the FERC, because regardless of what some counsel may say the FERC can or cannot do, if that Commission does not agree, such an opinion would have little standing on its own.

3. Your testimony notes that IPAA represents about 8,000 independent gas producers. What would be the financial impact on the members of your association from a two-year freeze of wellhead prices with a rollback to August 31, 1982 price levels?

As in the previous questions, there is no single answer -- each producer would represent a separate case. For example, a producer of old natural gas with a fixed price would experience no difference unless that contract was due to expire during those two years. At the other extreme, a producer of high cost gas may find his price frozen in at a level that may not otherwise be sustained due to other contract provisions. But as an industry, the overall freeze would have adverse economic effects.

While there would be cases under which such a freeze and rollback could put a producer out of business, more important is the impact that such price freeze would have on new gas drilling. Over the past decade, independent producers have consistently reinvested between 105 - 110 percent of wellhead revenues in new gas exploration and development. Recognizing that factor, any freeze, rollback or reduction in "real" wellhead revenues would result in a reduction in new energy production and development.

4. To what extent would a price freeze affect the exploration and production operations of your members?

We basically answered this question above, however, let us remind the Committee that anytime rigid price controls and freezes are placed on any commodity, the result is eventual shortages of that commodity which leads to later price increases which usually offset any presumed price benefits received during the control or freeze period. We feel that is what could be expected from a price freeze -- a drop in production followed by a shortage-driven price increase at the time the freeze is terminated.

(Democratic Questions)

1. I'm worried about what effect these "quick fix" bills could have on producers' ability to secure loans. Have you talked to any banks about these bills? What do they say? (You touch on this problem on page 8.)

In our discussions with the financial community, we find a good deal of concern. Honestly, we must say the biggest concern involves existing loans first, but prospective loans are in trouble simply because this type of legislation is being considered seriously. Most loans are made on the basis of anticipated income to repay such loans. A key factor in that repayment ability is found in conditions of sales contracts. Two key contract provisions which have represented important loan "collateral" have been indefinite price redetermination clauses and take-or-pay clauses. The first is obvious. Those clauses have given producers some assurance that their prices will reflect general economic changes in the industry. Obviously, if production costs increased without any price increases, a producer's ability to meet loan obligations would be hampered.

As to take-or-pay provisions, they are important in two areas. First, they afford a producer some assurances of uniform cash flow -- essential to meeting a loan repayment schedule.

But of secondary importance, take-or-pay clauses act as an important, needed discipline on purchasers. This is particularly important for small producers. Without some commitment to take gas from a well, a pipeline could simply shut in a producer with no recourse on his part. Thus, for a small producer with little or no "leverage" under other contracts, etc., the result of a drop in pipeline demand could quickly lead to 100 percent loss of cash flow. No banker would make a loan under such conditions.

Because of years of price conrols and because of the general structure of the gas industry, there is no "spot market" for gas as there is for most other commodities. Thus, if a pipeline has no obligation to take some minimum level of gas from a producer's well, that producer is left "high and dry" with nowhere to turn to convert his gas production into cash flow. Would you offer him a loan under those conditions?

2. Have any pipelines come to member companies in the IPAA to renegotiate contracts? If so, what has been your response? Have you surveyed your association to see what's happening?

We have done no formal survey of our membership to determine the level of renegotiation which is occurring. However, it is our belief, based on spot checks, that renegotiation of contract terms in widespread. Pipelines began last summer exercising "market out" clauses in new contracts. Those contract provisions have been the most prevalent in high cost gas contracts and the effect is to see prices paid under those contracts drop from the $7 - 9 range to $4.50 to $5.00.

In addition, for the limited number of pipelines with take-or-pay problems, our members report they are renegotiating terms when asked and where it is economically feasible to do so. Obviously, no producer is going to willingly renegotiate terms which could lead him to financial bankruptcy. However, it is our belief that the take-or-pay "problem" is not as widespread as many believe. A vast majority of the pipelines have not found it necessary to even consider renegotiation because past practices and market conditions have not led them to offer take-or-pay contracts inconsistent with current demand.

We find no producers unwilling to sit down with purchasers and try to resolve real problems. Producers know that they cannot succeed in the long term if gas is not able to compete in the market mix of fuels. Producers would be the first and biggest losers if gas becomes so overpriced because of contract rigidity that markets are lost to oil, coal and other fuels. But on the other hand, producers demand to know that any reductions they take are reflected in the market place and not used to pay bigger dividends to stockholders of pipelines and distribution companies or to subsidize increased imports, etc.

Accountability is important in any type of negotiation, and where need and general benefits to all segments of the industry can be seen -- including benefits to consumers -- producers are willing and eager to do their part.

JAMES A. MC CLURE, IDAHO, CHAIRMAN

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United States Senate
COMMITTEE ON
ENERGY AND NATURAL RESOURCES
WASHINGTON, D.C. 20510

January 3, 1983

Mr. Robert M. Brandon
Executive Director
Citizen/Labor Energy Coalition
Room 401
1300 Connecticut Avenue
Washington, D.C. 20036

Dear Mr. Brandon:

Attached are questions in follow-up to your appearance at the Committee's December 13, 1982 hearing on current conditions in the natural gas market. Please provide your responses to these questions to the Committee not later than the close of business January 17, 1983. If any clarification is needed you may contact Mr. Howard Useem (202-224-5205) of the Committee staff.

Sincerely,

James A. McClure

James A. McClure
Chairman

Enclosures

JAM:HU

QUESTIONS FROM REPUBLICAN MEMBERS OF THE COMMITTEE

1. In CLEC's opinion, if the use of take-or-pay provisions in producer/pipeline contracts were limited or eliminated altogether, would producers demand a higher price for their gas at the wellhead? If this were to occur, wouldn't the consumer savings from limiting the use of take-or-pay provisions be offset be higher wellhead prices?

2. What proportion of residential price increases experienced over the last year or anticipated for this winter are attributable to wellhead price increases as opposed to pipeline charges or changes in mix of NGPA category available to the pipelines?

3. In CLEC's opinion, what impact would the various proposals currently pending before the Committee*/ have on:

   --residential, commercial and industrial gas prices?
   --short-term and long-term gas supplies?
   --the financial situation of producers, pipelines and gas distribution companies?

4. In CLEC's opinion, to what extent and on what matters does the Federal Energy Regulatory Commission have the statutory authority to take action to address current and potential future problems in the gas market? Please provide the Committee with a detailed legal analysis of the FERC's authority. What actions would you recommend that the FERC take?

*/ S. 2074; S. 2892; S. 3028; S. 3054; S. 3069; S. 3070; S. 3076; S. 3088.

QUESTIONS FROM DEMOCRATIC MEMBERS OF THE COMMITTEE

QUESTIONS FOR CLEC (BOB BRANDON)

1. Do you know how natural gas prices compare with heating oil prices?

2. Is it equitable for consumers to have price controls on one commodity, but not on another commodity used for the same purpose?

3. Your statement (on pages 11-12) advocates a "comprehensive" solution. Do you support any of the bills now pending before this Committee? If so, which ones?

Official Committee File

citizen/labor energy coalition

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Washington Office

January

SENATE COMMITTEE ON
ENERGY AND NATURAL RESOURCES
RECEIVED
JAN 17 1983
WASHINGTON, D.C. 20510

Honorable James A. McClure
Chairman
Committee on Energy and Natural
Resources
3106 Dirksen Senator Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

Please find enclosed the reponses to the follow-up questions to my testimony given at the Committee's December 13, 1982 hearings on natural gas.

Again, I would like to thank you for the opportunity to participate in the hearing and to provide the Coalition's views on this most important issue.

Sincerely,

Robert M Brandon

Robert M. Brandon
Executive Director

Enclosure

Responses to Questions

1. In CLEC's opinion, if the use of take-or-pay provisions in producer/pipeline contracts were limited or eliminated altogether, would producers demand a higher price for their gas at the wellhead? If this were to occur, wouldn't the consumer savings from limiting the use of take-or-pay provisions be offset by higher wellhead prices?

   The ability of producers to demand higher wellhead prices to offset lower take-or-pay percentages depends on two factors: the elimination or increase in the ceiling price for the category of gas and the bargaining power of the producer versus that of the pipeline. (Since most producers appear to view the ceiling prices as statutory prices, little upward price movement could occur unless ceilings were revised upwards. The one exception would be Section 107 deregulated gas, which C/LEC recommends be capped to avoid pricing abuses.) For instance, in today's market the pipelines should logically be able to bargain both for lower prices and lower take-or-pay percentages. The failure of this to occur to any great extent suggests the severe structural problems in the gas market. It is because pipelines cannot be viewed as bargaining vigorously on their ratepayers' behalf that the Citizen/Labor Energy Coalition believes a limitation on take-or-pays alone will not solve the gas pricing problem. That limitation must occur in conjunction with a lowering and extension of ceiling prices, improved FERC regulations of PGAs and contractual provisions, and mechanisms for increased public participation.

2. What proportion of residential price increases experienced over the last year or anticipated for this winter are attributable to wellhead price increases as opposed to pipeline charges or changes in mix of NGPA category available to the pipelines?

   Between August 1982 and August 1983 (the latest month for which data is available), the wellhead price of natural gas increased by 47 cents per mcf (from $2.02 to $2.49). Over the same period the average price to residential users increased by 86 cents per mcf (from $4.70 to $5.56). Thus, the wellhead increase represented 55% of the increase to residential users. The remaining portion of the price to residential users is made up of pipeline and distributor costs. It should be noted that during the period in question pipeline costs have also increased because of higher wellhead prices. This is due to two factors: 1) decreased pipeline purchases (and/or sales plus increased storage) have reduced the pipeline's operating capacity with the result that higher fixed charges must be borne by consumers; 2) prepayments because of high take-or-pay provisions are also reflected in higher pipeline rates. Thus, it is more likely that two-thirds of the higher delivered gas prices to consumers are due to the increases in higher wellhead prices.

3. In CLEC's opinion, to what extent and on what matters does the Federal Energy Regulatory Commission have the statutory authority to take action to address current and potential future problems in the gas market? Please provide the Committee with a detailed legal analysis of the FERC's authority. What actions would you recommend that the FERC take?

   The Coalition believes that the FERC has ample authority under Sections 4 and 5 of the Natural Gas Act and Section 601 of the Natural Gas Policy Act to reform contract provisions which are contrary to the public interest.

Attached is a copy of our petition to the FERC on this question, which includes our analysis of the Commission's legal authorities and the recommendation that it hold a generic rulemaking on the contract problem in order to limit take-or-pays and other onerous contract provisions.

4. Do you know how natural gas prices compared with heating oil prices?

While in most areas residential natural gas prices are still lower than No. 2 heating oil, there are reported instances in the Northeast where prices have reached equivalency. Stephen Schachman, chairman of the Associated Gas Distributors and Chief Executive Officer of the Philadelphia Gas Works, testified last summer that "the Northeastern utilities are also coming close to parity with No. 2 fuel oil in the residential markets, not to mention propane and electric heat pump competition." (Testimony before the House Committee on Energy and Commerce, Subcommittee on Fossil and Synthetic Fuels, August 6, 1982.) Moreover, as financially-pressed industries argue for special rate relief from state public service commissions or switch to cheaper No. 6 oil, residential gas users can expect even larger rate increases.

5. Is it equitable for consumers to have price controls on one commodity, but not on another commodity used for the same purpose?

The Coalition opposed decontrol of oil and would prefer to have price protection for all fuels. To argue that decontrol of oil justifies decontrol of natural gas ignores the anti-competitive structure of the gas market, the existence of contract provisions that could raise gas prices above oil. The lesseons learned from the effects of oil price increases since decontrol began in 1979 -- inflation, unemployment, and lower productivity — should have warned us against the individual and national economic fallout which would be created by gas decontrol.

6. Your statement (on pages 11-12) advocates a "comprehensive" solution. Do you support any of the bills now pending before this Committee? If so, which ones?

There are elements in almost every bill pending before the Committee which the Coalition could support although there are provisions which we would want in a comprehensive bill missing from those bills. For instance, we believe that Congress must make clear that the FERC has not authority to increase Section 104 gas prices administratively and that it cannot provide incentive pricing under Section 107 unless proved necessary on cost grounds during an evidentiary proceeding.

BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION
Washington, D.C.

Take or Pay Clauses in)
Producer/Pipeline Contracts) Docket No. RM83-

PETITION OF THE CITIZEN LABOR ENERGY COALITION FOR RULEMAKING

SUMMARY OF PETITION

The Citizen/Labor Energy Coalition is asking the Federal Energy Regulatory Commission to initiate an expedited rulemaking proceding to provide the nation's gas consumers with immediate price relief from the consequences of high take-or-pay requirements in producer/pipeline contracts.

The Coalition has asked the Commission to stop pipelines from purchasing supplies of expensive gas while less expensive supplies are available. As pipelines take more expensive gas supplies under high take-or-pay contracts, they are shutting in large quantities of lower cost supplies. This results in substantial gas price increases to consumers and reduced income for many producers and royalty owners of lower-priced, shut-in gas.

Based upon the large quantities of gas shut-in nationwide (Business Week estimates 3 trillion cubic feet), the Coalition has estimated that consumers are paying $5 billion more for high priced U.S. and imported gas than if the lower priced shut in gas were available.

The operation of high take-or-pay requirements has helped to drive up prices (increases are averaging between 20% and 25% this winter). As a result hundreds of thousands of families will be disconnected this winter because they cannot afford the price of gas. Similarly, as large industrial users of gas pay higher bills, they are less able to survive in these hard economic times.

Under provisions of the Natural Gas Act (Sections 4 and 5) and the Natural Gas Policy Act (Section 601), the Commission has the authority to take action to alleviate the onerous take-or-pay clauses in producer/pipeline contracts. The Commission's mandate is to protect the public interest and assure that consumers obtain supplies of natural gas "at the lowest reasonable cost."

The petition asks the Commission to issue a rule limiting or reducing take-or-pay levels in existing contracts as well as any other action necessary to insure that any reduction in the cost of gas purchased by pipelines is immediately passed through to consumers this winter.

BEFORE THE

FEDERAL ENERGY REGULATORY COMMISSION

Washington, D.C.

Take or Pay Clauses in)
Producer/Pipeline Contracts) Docket No. RM83-

PETITION OF THE CITIZEN LABOR ENERGY COALITION FOR RULEMAKING

Pursuant to section 1.7(b) of the Commission's Rules of Practice and Procedure, 18 C.F.R. §1.7(b) (1981), the Citizen/Labor Energy Coalition (C/LEC) petitions the Federal Energy Regulatory Commission (FERC or Commission) to initiate an expedited generic rulemaking proceeding under the provisions of section 16 of the Natural Gas Act (NGA), 15 U.S.C. §717o, to provide immediate price relief to the nation's gas consumers by requiring modification of certain onerous producer/pipeline contract provisions.

INTEREST OF THE C/LEC

The C/LEC is a nationwide coalition of labor, community, senior, farm, environment and church organizations. These 300 groups represent approximately 13 million citizens. The Coalition is committed to representing the interests of consumers through efforts to obtain affordable energy prices.

CONSUMER HEATING COSTS AND WINTER DISCONNECTIONS

This winter heating season we have estimated that over 300,000 families who use natural gas to heat their homes will be disconnected because they can no longer afford the high cost of fuel. 1/ Moreover, in many parts of the country rising natural gas bills this winter are a major cause of concern and alarm. Prices this year are up 25% in Virginia and West Virginia, 21% to 28% in Pennsylvania, 22% in Utah, 60% in some areas of Missouri, 70% in parts of Southern California and 50% in Kansas. Cities like Peoria and Muncie, already devastated by unemployment and recession, are experiencing increases of 50% and 60%.

According to the General Accounting Office,

> The average residential price in October 1982 was $6.08 per thousand cubic feet, compared to $2.83 in October 1978...(not adjusted for inflation), according to Bureau of Labor Statistics data for U.S. cities. 2/

But residential consumers are not the only end-users of natural gas feeling the brunt of higher gas prices.

In many markets -- on the East Coast, in the Midwest, on the West Coast -- the delivered price of gas has already reached (and some cases surpassed) the price of alternative fuels (high sulfur No. 6 residual fuel oil). While some industrial users have the capacity to shift to lower priced alternatives, others, like most

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1/ "Cold and Dark: Utility Disconnections in the United States," a report by the Citizen/Labor Energy Coalition, October 26, 1982. These findings are based on a survey of state regulatory commission and local utility company information.

2/ Natural Gas Price Increases: A Preliminary Analysis, General Accounting Office, GAO/RCED-83-76, December 9, 1982, p. ii.

residential and commercial users, do not. As a result, higher natural gas prices become an added cost of doing business.

As residential users are forced to spend more of their income (even after making conservation investments to reduce usage) on natural gas, they have less income to spend on other items. This reduces the chances of economic recovery, because millions of consumers will not be in a position to spend their way out of recession. Similarly, industrial users will either have to pass along natural gas price increases in the form of higher prices for their manufactured goods, or absorb the cost increases, thereby reducing productivity and profitability.

Hard hit industrial users include the steel, automobile, glass, textile and chemical industries. Many of these industries are also located in what have become the most depressed areas of the nation's economy -- the Midwest and Northeast. As these industrial users pay more for natural gas, they are less able to survive in these hard economic times. And their products, reflecting higher natural gas prices, are less able to compete effectively with imports.

Some large industrial users, in particular fertilizer manufacturers, for whom natural gas represents a major cost component of their operations, have already felt the brunt of foreign competition. In the fertilizer industry, many plants have already shut down. Their output has been replaced by cheaper imports from the Soviet Union, Canada and Mexico. As one company recently stated,

> ...sales of ammonia at Olean, New York are being adversely affected by recent increases in the retail price of gas required as feedstock. Sales of ammonia to Agway, Inc. have been limited in recent months because of the poor demand for fertilizers in the farming industry. This situation has been worsened by the increasing price for natural gas. [3] Emphasis added.

As natural gas prices have been increasing--at an average rate of 22 percent per year [4]--large quantities of lower priced gas supplies are not being produced. According to Business Week, "as much as 3 trillion cu. ft. per year of domestic gas supplies currently are shut-in..." [5] One of the major driving forces responsible for these conditions is the widespread existence of high take-or-pay clauses in producer/pipeline contracts for the most expensive categories of gas under the NGPA.

PROBLEMS CAUSED BY HIGH TAKE-OR-PAY PROVISIONS

Take-or-pay provisions in pipeline/producer contracts require pipelines to buy and take delivery of either a high percentage (90%) or all of a producer's delivery capacity or pay for the quantities and "make up" delivery paid for, but not taken, at a later time. The Energy Information Administration has observed,

> These provisions may cause a purchaser to buy gas at a very high price under one contract with a high take-or-pay percentage, and at the same time refuse gas at a lower price from another contract with a low or non-existent take-or-pay percentage provision. Since the buyer could exercise some degree of monopoly power

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[3] Third quarter report to shareholders, Felmont Oil Corporation, November 9, 1982.

[4] GAO Report, op.cit., p.5.

[5] "Algeria's Low Gas Price Looks High in the U.S.," Business Week, August 23, 1982, p.27.

> (one buyer, many sellers) after the gathering lines and other equipment are in place, reasonable percentage (of the maximum quantity) take-or-pay provisions are usually considered necessary for the protection of the seller. With low percentage take-or-pay provisions there is an incentive for the seller to maintain a price that entices the buyer to purchase more gas. In today's market these provisions provide a method to ensure the sale of higher-priced gas. 6/

Thus, as pipelines shut in lower cost supplies of gas under contracts which permit lower takes and take higher cost gas under contracts which require higher takes, consumers are forced to pay much higher prices than if pipelines were in a position to purchase gas supplies on a least cost basis.

As was pointed out in the Comments of the Public Power Group in Docket RM82-26,

> Clearly, these contractual patterns prevent pipelines from obtaining their supply from the lowest-cost supplier, and, in fact, many low-cost suppliers are being cut back for long periods so that pipelines may take the high-priced gas. These contractual patterns
>
> > "deprive competitors of the right to compete, inhibit efficient allocation of resources and deny ultimate consumers the lowest price to which they are entitled." Lynchburg Gas Co. v. F.P.C., 336 F.2d 942 at 950 (D.C. Cir.1964).
>
> See also Northern Natural Gas Co. v. F.P.C., 399F.2d 953 at 965 (D.C. Cir. 1968).
>
> Under such circumstances, there can be little doubt that the Commission should and must take effective action to curb those contractual patterns which unreasonably restrain the free market and violate the very purpose sought to be achieved by both the antitrust laws and the regulatory statutes whose implementation has been assigned to the Commission. Northern Natural Gas Co. v. F.P.C., 399F.2d at 959, 965. 7/

6/Natural Gas Producer/Purchaser Contracts and Their Potential Impacts on the Natural Gas Market, Energy Information Administration, June, 1982.

7/Comments of the Public Power Group in Docket RM82-26, August 26, 1982, pp. 21-22.

In addition to the antitrust issue, the Associated Gas Distributors (AGD) have identified another important aspect of the take-or-pay problem.

> ....the pipeline prepayments problem is now one of extraordinary proportions. Based on a review of recent filings by five pipelines supplying gas to east coast market areas, the rate base of just these few pipelines would be inflated by prepayments amounting to over $900 million based on current contract exposure. The return and taxes allowable on this sum can be conservatively estimated at about $200 million annually. On a nationwide basis, the excess cost attributable solely to gas prepayments expense is obviously far more. 8/

High take-or-pay provisions in producer/pipeline contracts during a period of declining demand not only increase natural gas costs to consumers, but also reduce income for many producers and royalty owners whose wells have been shut in. In California, for example, Pacific Gas and Electric Company has high take-or-pay provisions in contracts for Canadian and Rocky Mountain gas, but not in contracts for gas produced in California. As a result, says Henry F. Lippitt II, executive secretary of the California Gas Producers Association,

> California natural gas producers are being asked to bear the brunt of reduced demand and increased supply. California producers have cut production to one-third of productive capacity. 9/

Similarly, Consolidated Oil & Gas, Inc. told its shareholders recently,

> The most severe cutbacks have occurred in the South Laredo field with third quarter production averaging only 3.1 million cubic feet per day, about 30 percent of capacity. In other areas, curtailments of 25 to 50 percent were experienced and we suspect this is partially due to pipelines' current purchasing practices. They seem to be favoring their

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8/Comments of Associated Gas Distributors in Docket RM82-26, August 26, 1982, p. 16.

9/ Oil & Gas Journal, July 19, 1982, p. 44.

> own production from deep decontrolled sources as well as imports from Canada and Mexico. The end result is higher prices to the consumer than would otherwise be charged.10/ Emphasis added.

Because demand for natural gas has declined, many pipelines have chosen to purchase high priced (Section 107) gas supplies under high take-or-pay contracts and to shut in lower priced (Section 104, 106, 103 and 102) gas supplies. The Kansas City Star recently reported that,

> Natural gas customers in Missouri, Kansas and 14 other states are likely to pay at least $545 million more for fuel in 1983 because of continuing reductions in the use of low-cost gas from the Hugoton field in southwest Kansas...11/

Similarly, The Baltimore Sun reported,

> Columbia, in a time of surplus, is buying larger and larger volumes of some of the most expensive gas on the market. At the same time, it is cutting back purchases of cheaper gas that would hold down prices.12/

And The Wall Street Journal reported,

> El Paso Co. is refusing to buy gas costing $2 to $3 a thousand cubic feet that it once bought from small producers in the San Juan Basin of New Mexico and delivered to customers in Southern California. But El Paso is still paying around $8 a thousand cubic feet for gas it buys in the Anadarko Basin of Oklahoma and then transports a far greater distance to the same customers in California.13/

10/ Third quarter 1982 report to shareholders, Consolidated Oil & Gas, Inc., October 21, 1982.

11/ "Gas Rate Increases Promise Cold Consumers," November 7, 1982.

12/ "Fuel Cost Soars Despite Surplus, Less Demand," September 19, 1982.

13/ "Gas Consumers Say Pipelines Are Paying More Than Necessary for Their Supplies," November 11, 1982.

IMPACT ON CONSUMERS

While it is not known with any precision how much of the gas that is shut in is Section 104, 106, 102, 103 or 107 gas, we have developed an analysis which assumes that most of the shut in gas is gas which is governed by the lower priced NGPA sections. This assumption is based on the evidence available in EIA studies and various reports in industry journals as well as local newspapers. Based on information contained in the Energy Information Administration's September 1982 report, "An Analysis of Post-NGPA Interstate Pipeline Wellhead Purchases," we have estimated that if lower cost shut in gas supplies were substituted for all of the quantities of Section 107 gas as well as 500 Bcf of imported gas (half the total), consumers would save, in 1982 alone, approximately $5 billion. This amount represents nearly 21 percent of the total cost of gas in 1982 to the customers of the interstate pipelines for purchases of wellhead gas supplies.

To arrive at this figure, we first must calculate the weighted average price of Section 104, 106, 103 and 102 gas purchases. This is shown in Table 1 below:

Table 1
(Mid-1982)

NGPA Section	Quantity (MMcf)	Price Per Mcf
Old Gas (104,106)	5,803	$1.29
Sec. 102	2,342	$3.20
Sec. 103	1,184	$2.86
Weighted Average Price		$1.97

We then calculate the 1982 cost of Section 107 gas: 664 Bcf X $7.24/Mcf amounts to $4.8 billion. These same volumes at the weighted average price would result in a cost of $1.3 billion. The difference is a savings of $3.5 billion. Similarly, with 500 Bcf of imports X $4.94/Mcf, the cost would be $2.5 billion. At the $1.97/Mcf price the total would be $1.0 billion for a difference of $1.5 billion. In other words, high take-or-pay provisions with domestic and foreign producers could result in an estimated $5 billion in higher consumer gas costs in 1982 alone.

Costs of this magnitude at a time when hundreds of thousands of families are having their gas heat disconnected can be avoided. Producers of lower priced Section 104, 106, 103 and 102 gas could be selling their gas were it not for the high take-or-pay provisions in pipeline/producer contracts for high priced gas.

OTHER PROBLEMS

The existence and operation of high take or pay provisions in producer/pipeline contracts may in fact be resulting in a serious violation of the Natural Gas Policy Act, unless the Commission acts to correct the abuse. In the NGPA Congress established that maximum lawful prices for gas "apply to any first sale of natural gas delivered during any month..." The term "deliver," according to the NGPA, "when used with respect to any first sale of natural gas, means the physical delivery from the seller..."

Under take-or-pay provisions, pipelines are making large pre-payments to producers without obtaining delivery of natural gas supplies. When a pipeline makes such a prepayment for gas not taken, it may pay the producer an amount which in fact exceeds the maximum lawful price allowed by Title I of the NGPA. Thus, when gas is not delivered but is nevertheless paid for, because of the take-or-pay provision, the producer is likely to receive a sum which, when divided by the amount "physically" delivered, yields a per Mcf or per MMBtu revenue higher than the maximum lawful price for gas in that category.

Another way in which take-or-pay provisions increase costs to consumers is if pipelines are unable to take physical delivery of the gas within the normal five-year make-up period provided by the Commission. Certainly, it is possible that a pipeline, because of changes in its market and the accumulation of take-or-pay obligations, may not be able to sell such gas. It is also true that drainage and the law of capture may reduce the production level of a particular well before make-up gas can be taken. Clearly, this is not a problem that consumers acting own their own behalf can remedy. It is an issue which the Commission must address.

COMMISSION'S MANDATE TO PROTECT CONSUMERS OF NATURAL GAS

An overarching purpose of the Natural Gas Act is "to protect consumers from exploitation by natural gas companies."16/ Thus, the Federal Energy Regulatory Commission has as its chief responsibility a legal mandate to insure that natural gas pipeline companies under its jurisdiction provide consumers with the lowest cost mix of natural gas. This mandate was reaffirmed in the Department of Energy Act in which one purpose was

> to promote the interests of consumers through provision of an adequate and reliable supply of energy at the lowest reasonable cost.

In fact the Commission recently recognized this mandate in Opinion No. 154.

Although this Opinion dealt principally with oil pipeline regulation, the Commission took the opportunity to point out that in its view oil pipeline regulation differed substantially from natural gas pipelines and electric utility regulation. Thus, with respect to the regulation of natural gas pipelines and electric utilities, the Commission argued that:

> Regulators strive, and should strive, for "the lowest reasonable rate." The statutes they administer were passed to help the consumer.
>
> Hence it is only natural for the regulators to resolve doubts in favor of the consumer.[15]

The Commission has, over the past few years, failed to adequately protect consumers and insure that the rates they pay are "the lowest reasonable rates." The Commission can no longer shirk its duty. The onset of winter, the sharp increase in natural gas prices to residential users, the existing glut of shut in lower priced gas supplies--all require the Commission immediately to use its available authority to require interstate pipelines to obtain and market the lowest price gas available.

The Commission has the authority as well as the obligation to rule invalid provisions of producer /pipeline contracts which do not serve the public interest. The Commission on December 16 correctly attempted to limit the operation of take-or-pay clauses in future producer/pipeline contracts in its policy statement. It is but a logical, but far more meaningful step, to limit such clauses in existing contracts.

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[15] Williams Pipeline Company, Docket No. OR79-1-000, et.al., November 30, 1982, p. 208.

While the Commission's authority to regulate producers was, for the most part, superceded by the Natural Gas Policy Act, the Commission's authority to regulate pipelines was left unchanged. In fact, Congress did permit the Commission to deny passthrough of gas costs under conditions of "fraud, abuse, or similar grounds." Therefore, pipeline/producer contracts are only valid if they meet public interest objectives, and parties to the contract both recognize that they are not operating in a market free of government regulation.

COMMISSION AUTHORITY

Under Sections 4 and 5 of the Natural Gas Act and under Section 601 of the Natural Gas Policy Act, the Commission has adequate authority to reform contract provisions which are antithetical to the public interest. Under Section 4, rates which are not "just and reasonable" are unlawful. Under Section 5, the Natural Gas Act requires the Commission to assure that the terms and conditions of natural gas contracts are not "...unjust, unreasonable, unduly discriminatory or preferential..." 15 U.S.C. 717d. According to this mandate the Commission has long possessed the authority to modify contract terms to best serve the public interest. See, e.g. Michigan Consolidated Gas Company v. Panhandle Eastern Co., 226 F.2d. 60 (6th Cir. 1955) and United Gas Pipeline Co. v. FERC 649 F.2d. 1110

(2d Cir. 1981). Indeed, "...the Commission has plenary authority to limit or proscribe contractual arrangements that contravene the relevant public interest." Permian Basin Area Rate Cases, 390 U.S. 747, 20 L Ed 2d 784 (1968).

The Commission's authority to regulate contracts under the NGA has been applied specifically to price escalation clauses and take-or-pay clauses. In Permian Basin the Supreme Court upheld the FPC's determination that indefinite price escalator clauses are contrary to the public interest and should not be permitted to operate under area rates. Ibid. at 782 As for take-or-pay clauses, the Commission issued rules alleviating pipeline obligations in Order No. 334, 37 FPC 110, (1967). See also FPC v. Sunray DX Oil Co., 391, U.S., 50-51 (1967).

In Florida Power & Light Co. v. FERC, 598 F.2d 370 (5th Cir. 1979), cert. denied, 444 U.S. 1013 (1980), the Commission imposed a certificate condition limiting the operation of a 1965 warranty contract between Amoco Production Company and Florida Power & Light Company which it had approved several years earlier. In its opinion the 5th Circuit affirmed the Commission's right to make changes in certain contract provisions stating "It seems, therefore, improper in a controlled industry to permit private parties to lock out such changes through contracts, albeit approved, which in effect prohibit that controlled industry from responding to those changing interests." 598 F.2d at 378.

Court opinions in *American Smelting & Refining Co*. v. *FPC*, 494 F.2d 925 (D.C. Cir 1974), *cert*. *denied*, 419 U.S. 882 (1974) and *FPC v. Louisiana Power & Light Co.*, 406 U.S. 621 (1972) demonstrate conclusively that the Commission has plenary power to limit or even abrogate contract terms in pipeline customer contracts if it finds that the public interest so requires.

There have been a number of pipelines which had the foresight or bargaining sense to include a so-called "market out" clause in their contracts. These "market out" clauses allow pipelines to renegotiate contracts at more reasonable prices, if they find they are unable to market the gas. Certainly, allowing all pipelines to include "market out" clauses in their contracts would do much to alleviate the current problems cuased by high take-or-pay requirements.

While the Commission has never used its authority to require "market out" clauses *per se*, its NGA authority under Sections 4 and 5 would be clearly sufficient to do so. While take-or-pay provisions operate to force pipelines or distributors to pay high prices to take unwanted quantities of gas, market-out clauses would release the pipeline or distributor from such obligations and require renegotiation of the contract at more reasonable prices. Thus, market-out clauses may be viewed as a means of ameliorating the harsh effects of take-or-pay clauses which the Commission has the authority to regulate and has, in fact, regulated.

While the NGPA curtailed the Commission's power to set wellhead prices, it did not reduce the Commission's powers to limit the operation of contracts harmful to the public interest. As argued in great detail by Associated Gas Distributors (AGD) in its comments in Docket No. RM82-26, the

> Commission's powers over contracts and practices affecting rates under Section 5(a) of the NGA retain their full force with respect to pipelines and producers subject to the Commission's jurisdiction under Section 1(b) of the NGA. Accordingly, the Commission's Section 5 powers give it full authority over producer and pipeline contracts to the extent that: (1) the
>
> the producer and pipeline rates are subject to the Commission's jurisdiction; (2) the contracts in question affect the rates to be charged; and (3) the Commission's action with respect to rates, contracts and practices affecting rates is prospective in effect and does not affect an "amount paid."

REQUEST FOR COMMISSION ACTION

To resolve these immediate and pressing problems, the Commission should issue a rule limiting or reducing take-or-pay levels in existing contracts. It should construe all existing contracts as containing market out clauses which can be exercised by pipelines to achieve least cost supply purchases.

The Commission should also take all other action necessary to insure that any reduction in the cost of gas purchased by pipelines is immediately passed through to consumers this winter;

or, in the alternative the Commission should not permit (as it has proposed for new contracts) pipelines which have take-or-pay provisions which exceed a reasonable level (50%) to pass through to consumers in Purchased Gas Adjustments or in rate base costs associated with take-or-pay provisions in excess of this reasonable level;

or, in the alternative the Commission should deny passthrough) of any Section 107 gas purchases or imported gas supplies, if there exist lower priced supplies which the pipeline is not taking;

or any other action which would allow lower priced, shut in gas to be sold to consumers and to insure that the lower priced gas available is reflected in rates charged to consumers this winter.

CONCLUSION

In view of the dramatic impact on the economy and consumers of skyrocketing prices this winter, the Commission must take immediate steps to ameliorate these price increases brought about, in large part, by high take-or-pay provisions in producer/pipeline contracts. We respectfully request that the Commission act swiftly to provide at least some relief to consumers from this winter's very costly heating bills. The Commission clearly has the power to deal with the take-or-pay problem on a generic basis in a rulemaking proceding. The Commision's recent (December 16) policy statement regarding the inclusion of high take-or-pay provisions in new contracts is an explicit recognition of the seriousness of the take-or-pay problem, although its decision has no effect on the very contracts that lie at the root of the hardships faced by consumers being shut-off and producers who are being shut-in.

Respectfully submitted,
Robert M. Brandon
Robert M. Brandon
Executive Director

December 20, 1982

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MICHAEL D. HATHAWAY, STAFF DIRECTOR
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D. MICHAEL HARVEY, CHIEF COUNSEL FOR THE MINORITY

United States Senate
COMMITTEE ON
ENERGY AND NATURAL RESOURCES
WASHINGTON, D.C. 20510

January 3, 1983

Mr. Stephen Schachman
Associated Gas Distributors
Suite 1200
1100 Connecticut Avenue, N.W.
Washington, D.C. 20036

Dear Mr. Schachman:

Attached are questions in follow-up to your appearance at the Committee's December 13, 1982 hearing on current conditions in the natural gas market. Please provide your responses to these questions to the Committee not later than the close of business January 17, 1983. If any clarification is needed you may contact Mr. Howard Useem (202-224-5205) of the Committee staff.

Sincerely,

James A. McClure

James A. McClure
Chairman

Enclosures

JAM:HU

QUESTIONS FROM REPUBLICAN MEMBERS OF THE COMMITTEE

1. The Associated Gas Distributors note in their written testimony (p.2) that they have four areas of concern with respect to natural gas policy:

   1. the need to bring retail gas market signals more quickly and accurately to the wellhead market;
   2. the need to assure that gas distributors can be informed as to the supply acquisition prices and practices of their suppliers and that they can act to protect their interests;
   3. the need to remove the economic windfalls to natural gas producers under the NGPA; and
   4. the need to enhance interstate gas supply security though regulation of pipeline transportation service.

   Q. In AGD's opinion, do any of the proposals currently pending before the Committee*/ address satisfactorily all of these concerns?

2. On p. 6 of AGD's testimony it urges Congress to amend NGPA Sec. 601 (c)(2) to include a "prudence" standard for pipeline purchases of natural gas.

   Q. In AGD's opinion, why can't the FERC achieve this objective using their authority under Sec. 5 of the Natural Gas Act?

   Q. Isn't the FERC looking at this matter right now in their Tennessee Gas Pipeline proceedings?

3. AGD's testimony outlines various problems that distributors are currently encountering and believe that will occur in the near future as the NGPA plays out.

   Q. In AGD's opinion, do any of the proposals currently pending before the Committee */ address all of the various aspects of the "natural gas problem"?

   Q. In AGD's opinion, what impact would the various proposals currently pending before the Committee */ have on:

   --residential, commercial and industrial gas prices?
   --short-term and long-term gas supplies?
   --the financial situation of gas distributors?

4. In AGD's opinion, to what extent and on what matters does the Federal Energy Regulatory Commission have the statutory authority to take action to address current and potential future problems in the gas market? Please provide the Committee with a detailed legal analysis of the FERC's authority. What actions would you recommend that the FERC take?

*/ S. 2074; S. 2892; S. 3028; S. 3054; S. 3069; S. 3070; S. 3076; S. 3088.

QUESTIONS FROM DEMOCRATIC MEMBERS OF THE COMMITTEE

QUESTIONS FOR AGD (STEVE SCHACHMAN)

1. Have you analyzed the price freeze bills, and the take or pay revocation bills, which are pending before this Committee? Do you support them?

2. How soon would consumers feel any price relief, if the legislation were enacted by December 31?

AGD

ASSOCIATED GAS DISTRIBUTORS Suite 1200, 1100 Connecticut Ave., N.W., Washington, D.C. 20036 202-430-5329

SUPPLIERS OF GAS TO CONSUMERS ON THE EASTERN SEABOARD

Baltimore Gas and Electric Co.
Bay State Gas Co.
The Berkshire Gas Co.
Boston Gas Co.
The Brooklyn Union Gas Co.
Cape Cod Gas Co.
Central Hudson Gas and Electric Corp.
Chesapeake Utilities Corp.
City of Holyoke, Mass., Gas and Electric Dept.
City of Westfield Gas and Electric Light Dept.
Commonwealth Gas Co.
Concord Natural Gas Corp.
The Connecticut Gas Co.
Consolidated Edison Company of New York, Inc.
Delmarva Power and Light Co.
Elizabethtown Gas Co.
Fitchburg Gas and Electric Light Co.
Gas Service, Inc.
Haverhill Gas Co.
Long Island Lighting Co.
Lowell Gas Co.
Lynchburg Gas Co.
Manchester Gas Co.
New Jersey Natural Gas Co.
New York State Electric and Gas Corp.
North Carolina Natural Gas Corp.
Northeast Georgia Municipal Gas Utilities
Northern Utilities, Inc.
Pennsylvania Gas and Water Co.
Pequot Gas Co.
Philadelphia Electric Co.
Philadelphia Gas Works
Providence Gas Co.
Public Service Company of North Carolina, Inc.
Public Service Electric and Gas Co.
South County Gas Co.
South Jersey Gas Co.
The Southern Connecticut Gas Co.
UGI Corporation
Valley Gas Co.
Washington Gas Light Co.

January 17, 1983

SENATE COMMITTEE ON
ENERGY AND NATURAL RESOURCES
RECEIVED
JAN 17 1983
WASHINGTON, D.C. 20510

The Honorable James A. McClure
Chairman
Committee on Energy and Natural
Resources
United States Senate
Room 3106
Dirksen Senate Office Building
1st and C Streets, N.E.
Washington, D.C. 20510

Dear Chairman McClure:

On December 13, 1982, Mr. Stephen Schachman, Chairman of Associated Gas Distributors, testified before your Committee concerning current conditions in the natural gas market. On January 3, 1983, you requested AGD to respond to certain follow-up questions by January 18, 1983. This letter responds to that request.

1. The Associated Gas Distributors note in their written testimony (p.2) that they have four areas of concern with respect to natural gas policy:

   1. the need to bring retail gas market signals more quickly and accurately to the wellhead market;
   2. the need to assure that gas distributors can be informed as to the supply acquisition prices and practices of their suppliers and that they can act to protect their interests;
   3. the need to remove the economic windfalls to natural gas producers under the NGPA; and
   4. the need to enhance interstate gas supply security through regulation of pipeline transportation service.

   Q. In AGD's opinion, do any of the proposals currently pending before the Committee address satisfactorily all of these concerns?

AGD Response:

None of the bills cited in the question contains language which satisfactorily addresses all four of the concerns mentioned in AGD's testimony. Several of these bills (S. 2892, S. 3028, S. 3054, S. 3070, S. 3076, and S. 3088) contain provisions which would respond to the first-mentioned concern, *i.e.*, the need to enhance the flow of market signals between the segments of the natural gas industry. None of these bills, however, address the other three AGD concerns listed in your first question.

2. On p. 6 of AGD's testimony it urges Congress to amend NGPA Section 601(c)(2) to include a "prudence" standard for pipeline purchases of natural gas.

   Q. In AGD's opinion, why can't the FERC achieve this objective using their authority under Sec. 5 of the Natural Gas Act?

   Q. Isn't the FERC looking at this matter right now in their Tennessee Gas Pipeline proceedings?

AGD Response:

AGD believes FERC *could* exercise its Natural Gas Act Section 5 authority to deny interstate pipelines the ability to recover imprudently incurred purchased gas costs on a *prospective basis*. AGD asserts that this authority could be exercised to prevent the recovery of costs to be incurred in the future pursuant to high-percentage take-or-pay contract provisions, indefinite escalator pricing provisions or any other contract provisions which were shown to impair the pipeline' ability to purchase gas on a least cost basis. FERC *may* intend to use this authority in the Tennessee proceeding, based on its statements in the October 1, 1982 order in Docket No. TA82-2-9.

AGD's interest in legislation which establishes the prudence standard as the basis for allowing pipelines to recover amounts paid for gas is designed to provide an appropriate standard for determining whether a cost *already incurred* by a pipeline should or should not be allowed or approved as an element of a pipeline's costs in determining its rates. Under current FERC policy, costs incurred imprudently by a pipeline are not subject to disallowance unless there is a further finding that such costs were excessive due to some kind of "misrepresentation" by the pipeline. While AGD disagrees with the current FERC policy and believes that the "misrepresentation" standard is not what NGPA requires, the fact is that FERC currently follows that policy insofar as it reviews costs already incurred by an interstate pipeline.

3. AGD's testimony outlines various problems that distributors are currently encountering and believe that will occur in the near future as the NGPA plays out.

   Q. In AGD's opinion, do any of the proposals currently pending before the Committee address all of the various aspects of the "natural gas problem"?

   Q. In AGD's opinion, what impact would the various proposals currently pending before the Committee have on:

   -- residential, commercial and industrial gas prices?
   -- short-term and long-term gas supplies?
   -- the financial situation of gas distributors?

AGD Response:

None of the bills recited in your questions addresses all aspects of the "natural gas problem" as the latter is defined in AGD's testimony.

Some of the bills mentioned in your questions would modify or excuse entirely the interstate pipelines' obligations to purchase gas under contracts containing high percentage take-or-pay provisions and indefinite price escalator provisions and some of these bills would require the pipelines to purchase gas on a least cost basis under contracts which have been substantially revised pursuant to new statutory standards governing take-or-pay and indefinite price escalators. AGD believes that those bills which either (a) make unenforceable high percentage take-or-pay commitments and indefinite price escalators or (b) deny pipelines the ability to recover in their rates the costs incurred under high percentage take-or-pay commitments or indefinite price escalators and which mandate a least cost approach to pipeline gas purchasing would have a variety of favorable effects. Such legislation would yield lower retail prices for natural gas for residential, commercial and industrial consumers, would improve the long-term supply of gas and would enhance the financial situation of gas distributors. The bills which would have these favorable effects are S. 2892, S. 3028, and S. 3070.

Those bills which would impose a freeze on prices (such as S. 3054) or which would expire in a short time (such as S. 3076) are not likely to provide lasting solutions to the gas industry pricing problems, although they may include some desirable provisions (such as Section 3(a) of S. 3054 and Section 5(a) of S. 3076).

4. In AGD's opinion, to what extent and on what matters does the Federal Energy Regulatory Commission have the statutory authority to take action to address current and potential future problems in the gas market? Please provide the Committee with a detailed legal analysis of the FERC's authority. What actions would you recommend that the FERC take?

AGD Response:

FERC's statutory authority to take action to address current and potential future problems in the gas market is outlined in AGD's Comments of August 26, 1982 in FERC Docket No. RM82-26. A copy of those Comments is attached. As stated at pp. 51-53 of these Comments, AGD believes FERC should exercise its authority to regulate interstate pipelines' purchasing practices and contracts which affect such pipelines' rates in a general rulemaking proceeding. In such a rulemaking proceeding, FERC should declare that pipeline gas supply agreements containing indefinite price escalator provisions and/or high-percentage take-or-pay provisions (as defined in the rulemaking proceeding) are unjust and unreasonable and therefore unenforceable because such provisions prevent the pipeline from (a) responding to changes in customer demand or other market forces and/or (b) purchasing gas from all its sources on a least cost basis.

AGD appreciates this opportunity to provide its views to the Committee.

Respectfully submitted,

Frederick Moring

Frederick Moring
Counsel for Associated Gas
Distributors

Attachment

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Impact of the NGPA on Current and Projected Natural Gas Markets	)))	Docket No. RM82-26

COMMENTS OF ASSOCIATED GAS DISTRIBUTORS

The Notice of Inquiry issued April 28, 1982 in this proceeding raises three broad questions of overriding importance to all elements of the natural gas industry. These are:

1. What market distortions exist now and/or will become serious economic problems within the natural gas industry in 1985?
2. What legal authority is available to the Commission to resolve the problems presented by existing or foreseeable market distortions?
3. Should the Commission use its authority to increase ceiling prices for flowing gas, thus eliminating the vintage price concept from the NGPA wellhead ceiling price rate structure?

AGD's response to these questions may be summarized as follows:

Market Distortions Resulting From Contract Provisions

The widespread use of indefinite price escalator clauses and high percentage take-or-pay clauses in wellhead gas sales contracts is now and will be in 1985 the most significant source of industrywide market distortions. The problems derived from these contracting practices are well demonstrated in various filings made with this Commission and in the several studies and reports issued in recent months by EIA, DOE and by recognized industry associations.

Legal Authority to Regulate Indefinite Escalators and Take-or-Pay Provisions

There is an adequate legal basis in the NGPA and NGA and a sufficient factual basis in the studies available to the Commission and in filings made by various pipelines upon which the Commission can and should take action on the "contracts problems." It should promptly acknowledge the serious market disorders attributable to certain contracting practices and, accordingly, act to nullify the prospective effect of indefinite price escalator provisions and restrain the future impact of high percentage take-or-pay provisions in contracts which affect the rates of natural gas companies subject to its jurisdiction.

No Justification For Raising Flowing Gas Prices

The proposal to increase the NGPA ceiling prices for flowing gas cannot be justified. The substantial economic windfall created by that proposal (for flowing gas producers) would have a serious negative impact on natural gas sales and on the search for new gas reserves; it would not yield competitive parity among purchasers of new gas reserves. Moreover, the vintage pricing concept is so fundamental to the NGPA rate structure that its complete removal or abandonment is a revision for which the Commission lacks legal authority.

In the remaining portion of these comments, we explain the factual and legal basis for the foregoing conclusions.

I. MARKET DISTORTIONS CAUSED BY CERTAIN CONTRACT PROVISIONS

A. Introduction.

On April 28, 1982, the Commission issued a Notice of Inquiry (NOI) in Docket No. RM82-26, Impact Of The NGPA On Current And Projected Gas Markets. In its NOI, the Commission solicited comments on the likelihood of serious economic distortions evolving in the nation's natural gas markets, as well as the scope of the Commission's authority to act to reduce any such distortions. The NOI was prompted in large part by several rulemaking petitions filed with the Commission by various regulatory and industry groups, asking it to take specific actions to avert serious market dislocations in the next few years. NOI at 24-28.[1]

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[1] Groups filing such petitions included the Process Gas Consumers Group et al., Laclede Gas Company, the People of the State of California, the Public Utilities Commission of the State of California, the National Association of Regulatory Utilities Commissioners, and Associated Gas Distributors. Id.

The concerns of these groups stem in part from unforeseen events that have transpired since the passage of the Natural Gas Policy Act of 1978, 15 U.S.C. § 3301 et seq. (Supp. IV 1980) (NGPA). The Commission stated the problem in its NOI:

> Congress expected that the NGPA pricing mechanisms would result in a smooth transition to partial decontrol in 1985. For example, it appears that Congress intended that the prices under the NGPA for certain new supplies would escalate at a rate which would make them equivalent to the price of oil by 1985. However, because of rapid unforeseen increases in world oil prices since passage of the NGPA, many now speculate that the NGPA growth rate will fail by a wide margin to reach a price equivalent to the adjusted price of oil, which is considered by some to be the market clearing price of natural gas.

NOI at 18-19. These groups fear that this disparity between the prices of gas and oil will result in a "fly-up" of natural gas prices in 1985, causing newly-deregulated prices to rise to levels in excess of the Btu-equivalent cost of oil.

B. Contract Provisions Are The Cause Of Both Existing And Foreseeable Market Disorders.

Unfortunately, realization of this "fly-up" is virtually assured by the prevalence of what are known as indefinite price escalator (IPE)[2] and take-or-pay (TP)[3] clauses in interstate natural gas sales contracts between pipelines and producers. As the Commission stated in its NOI:

> The potential for a sharp price increase in 1985 may be affected not only by the then existing price of oil, but also by the existence of indefinite price escalation clauses and take-or-pay requirements in gas purchase contracts. Many contracts contain indefinite price escalation clauses of various kinds. Some require that in 1985, the contract price will rise to the price equivalent of 110 percent of No. 2 fuel oil (home heating oil). Others require a price rise to the average deregulated price paid for other gas in the same county or region. When these pricing terms are combined with high take-or-pay contract requirements (which mean that a pipeline does not have the flexibility to avoid paying for high priced gas even though it may not currently need the gas for its customers or may have other, cheaper supplies available), there is great concern by some that the price

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[2] IPE clauses are clauses that permit the price of gas to be reset periodically by reference to a standard external to the contract. Examples are clauses that tie the price to the highest price paid by a buyer to another seller of comparable gas (most-favored-nation clause); clauses that tie the price to an average of the two or three highest prices paid by any buyer for comparable gas in a given area (renegotiation clause); clauses that tie the price to the highest price permitted by law; and clauses that tie the price to a certain percentage (often 110 percent) of the price of another fuel (often No. 2 fuel oil).

[3] TP clauses require a buyer of natural gas to take delivery of a fixed percentage of the volumes produced from a well over the course of a certain time period (often a month or a year). If the buyer cannot take delivery, it must still pay the seller for these volumes. Many recent contracts in the Gulf Coast producing areas specify take-or-pay requirements of 90 percent of the deliverable amount.

> increase in 1985 will go even beyond the market clearing price creating a temporary "spike" in gas prices.

NOI at 19-20.

The true dimensions of this problem are more alarming than the Commission's statement indicates. Several studies issued in recent months have concluded that the widespread use of IPE and TP clauses in producer/pipeline contracts both before and after the NGPA will trigger a sharp "fly-up" in natural gas prices which will in turn create serious market disorders unless these clauses are renegotiated or abrogated.[4/] The dramatic "price spike" effect of indefinite price escalators is not contingent upon a steady increase in world oil prices which exceeds the expectations of Congress when it enacted NGPA. That effect is assured by the widespread use of "most-favored-nation" type pricing provisions, which cause the highest price paid by any purchaser in a given producing area or state to become the generally effective price throughout a large portion of the wellhead sales marketplace, even

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[4/] *See, e.g.*, *Analysis of Natural Gas Producer/Interstate Pipeline Contracts*, July 1, 1981, prepared by Decision Analysis Corporation for the American Gas Association; Statement of Jerome J. McGrath, President, Interstate Natural Gas Association of America before the Senate Committee on Energy and Natural Resources, November 6, 1981; Petition of the National Association of Regulatory Utility Commissioners for Rulemaking on Take-Or-Pay Clauses in Producer/Pipeline Contracts, Docket Nos. RM82-20 and RM82-21 (filed March 12, 1982; *Natural Gas Producer/Purchaser Contracts and Their Potential Impacts On The Natural Gas Market: An Analysis of the NGPA And Several Alternatives*, Part II (EIA Study, Prepublication Draft released June 25, 1982).

though the average price of crude oil and or No. 2 fuel oil may decline over the next few years. Moreover, high percentage TP provisions in many of these contracts are already causing serious excess deliverability problems. This has resulted in the grant of extensive off-system sales authority to permit pipelines to relieve themselves of excessive volumes at prices considerably less than the marginal cost of acquisition. The present impact of high percentage TP provisions is also manifesting itself (a) in large amounts of prepayments for gas paid for but not taken for which the pipelines are seeking approval of the Commission in Section 4 rate filings and (b) in the number of rate design proposals made in recent pipeline rate proceedings which call for a shifting of more costs to the demand component of pipeline rates, with commodity charges reduced in an effort to make gas more marketable.

The cited government and industry studies, together with the various filings and proposals coming before the Commission in pipeline proceedings, present substantial evidence that TP clauses are now causing, and that in 1985 both TP and IPE clauses will cause, serious public harm unless the Commission or Congress takes some action to limit their operation. These studies are based on a review of hundreds of pre- and post-NGPA contracts. The range of pipeline proposals seeking to avoid the market consequences of too-high prices are based on the general softening of natural gas markets in all areas. These developments validate the concerns expressed in the rulemaking petitions filed by industry and regulatory groups cited above.

C. Problems Caused By Indefinite Price Escalation Provisions.

The recent EIA Study cited above includes the following findings regarding the prevalence of IPE clauses in gas contracts and concludes that the presence of such clauses in contracts affecting only one percent of total contract quantities scheduled to be deregulated in 1985 will be sufficient to trigger a chain reaction fly-up because of the operation of most-favored-nation clauses. For contract quantities covering post-NGPA wells the EIA Study states that:

> Overall, contracts covering approximately 59 percent of the contract volume of post-NGPA wells have deregulation clauses. For contracts signed since the passage of the NGPA, however, that proportion has increased to over 70 percent.
>
> Contracts signed during the year and a half immediately preceding the 1978 passage of the NGPA, the period during which the NGPA was debated in Congress, show the highest proportion of oil parity clauses in deregulation price terms and a low percentage of buyer protection clauses which allow the buyer relief from high prices.
>
> Of those contract quantities with deregulation provisions, 76 percent have most-favored-nation clauses, 21 percent have oil parity clauses, and 21 percent have market-out clauses if the gas is not marketable at the redetermined price.
>
> Approximately 3 percent of the interstate contract quantities and less than 1 percent of

> the total contract quantities which are scheduled for deregulation in 1985 have an oil parity provision but no market-out provision.

For pre-NGPA interstate contract volumes the EIA Study states that:

> Sixty-six percent had deregulation provisions, 26 percent were tied to the highest regulated rate with no deregulation provisions, and 8 percent had definite-only escalators.
>
> Almost all contract volumes with deregulation provisions had most-favored-nation clauses, predominately three-party type.
>
> Only 12 percent of the volumes associated with deregulation clauses was tied to oil prices, most of which was tied to No. 2 fuel oil prices.
>
> Six percent of the volumes with deregulation clauses also had market-out clauses which allowed the buyer to be released from the contract if the price did not allow the gas to be marketed.

EIA Study at 53, 55.

The EIA study further reports that, since passage of the NGPA, oil parity price provisions have become less frequent, and those contracts with oil-tied price provisions include more buyer protection in the form of "market-out" and "FERC-disallowance" provisions. While only 3 percent of the interstate quantities and 1 percent of the total contract quantities scheduled for deregulation in 1985 have an oil parity provision with no market-out provision, the EIA Study concluded that this relatively small amount will be sufficient to trigger the 1985 "fly-up." As stated in the study:

> Although the total quantity decontrolled under the NGPA in 1985 with oil parity clauses and no market-out provision is small compared to the total supply, this quantity is assumed to be enough to trigger the fly-up by itself, without any new contracts of this type from 1980 to 1985, for two reasons. First, this quantity of gas represents production from up to 400 wells or more. Second, even though less than 1000 contracts were sampled (out of 30,000 to 50,000 or more estimated to be currently in force), the sampled wells that will be decontrolled in 1985 with oil parity and no market-out provisions included purchases by five major interstate pipelines and sales by three major producers and nine independent producers. This dispersion leads to the assumption that the problem is not sufficiently localized and, therefore, that these contracts could constitue a "critical mass" for the contagion. If these types of oil parity clauses are renegotiated or abrogated and no new such contracts appear in the future, the "fly-up" would probably not occur.
>
> Since favored-nation clauses are sometimes triggered by the single highest price in a large area (for example, South Louisiana onshore and offshore), the contagion or chain reaction effect could, in theory, be caused by a single contract. These contracts could then trigger another and so on. The question becomes how fast, not whether this contagion occurs. Renegotiation or other intervention, therefore, becomes an option for preventing this problem.

EIA Study at 50.

Assuming no renegotiation and no intervention by the Commission or Congress, the EIA Study estimates that the 1985 "fly-up" would increase average wellhead prices (in 1980 dollars) for interstate gas in the range of 21 cents to 84 cents per MMBtu and, for intrastate gas, in the range of 16 cents to $1.49. The corresponding additional revenue to producers in 1985 is estimated in the range of $3.6 billion to $16.5 billion.

Like the EIA Study, the study prepared by Decision Analysis Corporation for the American Gas Association, cited above, concludes that deregulation provisions, including IPE clauses, now exist in approximately two-thirds of all gas purchase contracts, and in virtually all contracts entered into since the NGPA. The DAC/AGA study also concludes that the effect of IPE clauses would be to cause a sharp increase in average wellhead prices between 1984 and 1985, causing wellhead prices after deregulation to considerably exceed market clearing prices. The DAC/AGA study further agrees with the EIA Study on the point that a few contracts could have widespread impact by triggering favored-nation clauses found in the great majority of all gas contracts.

The survey conducted by INGAA cited above consisted of data collected from 24 pipelines which in 1979 purchased or produced 96.6 percent of the interstate supply from field sales or company-owned production. The principal focus of the data requested was to determine, in the aggregate, the pipelines' estimates of future gas mix and the volume of such gas which would be subject to the operation of indefinite pricing clauses. The survey results indicate that approximately 83 percent of interstate natural gas production to be decontrolled on January 1, 1985, will be subject to

IPE clauses. This compares with 87 percent of contract volumes covered by deregulation provisions estimated by the EIA. The INGAA survey estimates that the average U.S. gas field acquisition price will increase from approximately $4.50 per MMBtu in 1984 to about $8.00 in 1985. This 80 percent increase is based on the assumption that IPE clauses will cause wellhead prices for deregulated volumes to rise to a level equivalent to 110 percent of the wholesale price of No. 2 fuel oil.

The INGAA study is based on a broad-based analysis of gas supply contract data from the files of interstate gas pipelines; all of the contracts on which this study is based are either on file with the Commission or are readily available to the Commission through the use of its NGPA Section 315(c) authority.5/ The conclusions reached by the INGAA report are entitled to substantial weight in this proceeding. Certainly the Commission is in a position to authenticate or verify INGAA's findings by reference to its own rate schedule files, which could be readily supplemented to include all first sale contracts, if there are any questions as to the validity of INGAA's contracts study.

All three of the studies discussed above, therefore, establish the fact that a very large percentage of natural gas produc-

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5/ A series of formal requests have been made by AGD and others seeking to have the Commission exercise this authority. To date, these requests have been ignored by the Commission except in a limited number of individual pipeline PGA cases, where contracts have been provided primarily on a confidential basis to "reviewing parties".

tion, particularly in the interstate market, is covered by IPE clauses. These clauses affect approximately two-thirds of pre-NGPA interstate gas production and over 80 percent of the interstate volumes to be deregulated in 1985. The studies further agree on the point that most-favored-nation clauses are the dominant factor and that the existence of any oil parity contract can have a profound effect on the magnitude of the fly-up of prices upon deregulation.

D. Problems Caused By Excessive Take-Or-Pay Provisions.

The vast majority of existing contracts for the sale of natural gas by producers to pipelines contain take-or-pay provisions. These provisions cause serious distortions in the natural gas market which, in turn, cause significant problems that will only be exacerbated by deregulation of gas prices.6/

TP provisions obligate purchasing pipelines to buy and take delivery of either a high percentage or all of the producer's delivery capacity or pay for the quantities and "make up" delivery

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6/ *See generally* the June 17, 1981 Report to the NARUC Gas Committee on Take-or-Pay Contracts attached to the NARUC Petition cited in note 4 *supra*. The take-or-pay problem discussed in this section with respect to the producer/pipeline interface, also arises at the pipeline/distributor interface because of the presence of minimum bill provisions in many pipeline tariffs. These minimum bill provisions produce the same type of "market guarantee" and market disordering effects as the producer/pipeline take-or-pay provisions. The Commission's authority to act on this problem is clear. We urge the further investigation of it by the Commission in an appropriate proceeding.

paid for, but not taken, at a later time. Although the specific terms of the provisions vary from contract to contract, TP provisions typically contain the following elements:

1. The purchaser agrees to buy a relatively high percentage of the seller's delivery capacity (according to the EIA Study, this percentage which generally shifts slightly downward over time, ranges as high as 97.8 for Section 108 stripper well gas to an average of 75.8 percent for Section 107, high cost gas);
2. If the purchaser fails to take the minimum quantity, he must nevertheless pay for the minimum quantity at the then applicable contract price;
3. The purchaser is permitted to make up any quantities paid for but not taken during the five years succeeding the deficiency period by applying any amounts taken in excess of the succeeding years' minimum take obligations against the existing deficiency;
4. When and if the purchaser makes up the deficiency, the purchaser must pay the producer the difference between the price already paid for the gas and the price in effect at the time the gas is actually delivered;

5. The purchaser receives no refund for gas that is not made up during the make-up period.

Some form of TP provisions may be justified to the extent that they (a) guarantee a certain necessary cash flow to producers and (b) prevent drainage of the producers' reserves by other producers. At the same time, however, high percentage TP's force pipelines to take gas for which they may not have an already existing market among their system supply customers. The problems caused by this manipulation of market forces are severe.

The most significant problem caused by excessive provisions is unnecessarily high gas prices to consumers. Excessive TP provisions result in increased gas prices to the purchasing pipeline's system supply customers for several reasons. First, TP provisions actually inhibit pipelines from purchasing daily gas supplies on a least cost basis. This is so because pipelines, in an effort to avoid TP liability, often take higher cost gas under contracts with high percentage TP provisions and either reduce or shut-in their purchases of lower cost gas under contracts which permit lower takes or which involve substantially lower prepayments for gas not taken (because the unit price is lower).

Second, because the typical TP obligation is geared to the productive capacity of the producing well, rather than to the volume of proved reserves in place, and because the average productive life of wells has been shortened over the last ten years, pipelines have been obligated to install larger and larger pipeline facilities in order to accommodate their minimum TP obligations. Due to the shortened production life of the wells, the larger installed pipeline capacity actually has a shorter depreciation life. This situation yields a larger than necessary rate base which must ultimately be paid for by the pipeline's customers and an increase in the pipeline's depreciation charges to its customers.

Finally, and perhaps most important, the pipeline prepayments problem is now one of extraordinary proportions. Based on a review of recent filings by five pipelines supplying gas to east coast market areas, the rate bases of just these few pipelines would be inflated by prepayments amounting to over $900 million based on current contract exposure.7/ The return and taxes allowable on this sum can be conservatively estimated at about $200 million annually. On a nationwide basis, the excess cost attributable solely to gas prepayments expense is obviously far more. By any standard, it is apparent that the cost burden arising from TP contracting practices is truly enormous.

The increased costs to natural gas consumers become even greater if the pipeline is unable to make up the quantities of gas within the five-year period prescribed by the Commission. And

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7/ The filings reviewed included those of the following pipelines: Columbia Gas Transmission Corp., Tennessee Gas Pipeline Company, Texas Eastern Transmission Corp., Transcontinental Gas Pipeline Corp., and United Gas Pipe Line Corp.

despite the five-year make-up period required by the Commission under Section 154.103 of its regulations, pipelines may find that gas paid for, but not taken, cannot be made up. In some cases, a pipeline may be unable to find a sufficient market for the gas. In other cases, drainage and the law of capture may reduce the production level of a particular well before make-up gas can be taken. Pipelines may have no recourse because producers typically refuse to include in their sales contracts any warranty that gas will be available for make-up.

The operation of TP make-up provisions raises a serious legal issue which the Commission has so far either ignored or disregarded. When a pipeline makes a prepayment for gas not taken, it may well furnish its producer supplier an amount which exceeds the maximum lawful price permitted for natural gas by NGPA Title I. In accordance with the pricing provisions of that Title, the maximum lawful price applies to the natural gas "delivered" during any month. Where natural gas is not delivered but is nonetheless paid for (by reason of a TP provision), the producer seller may (and probably will) receive a sum which, when divided by the amount actually delivered, yields a per-MMBtu revenue in excess of the permissible ceiling price for gas of that category. On this reasoning, the Commission has a solid basis for investigating the legality of the large prepayments received by producers under TP provisions. To the extent such prepayments result in receipts at levels above the maximum lawful prices established by NGPA for gas deliveries,[8] they should obviously not be allowed as pipeline rate base items.

There are other market distortions caused by TP provisions that may cause additional, but as yet unidentified, problems. Perhaps the most significant market distortion is the insulation of producers from market forces. Under free market conditions, a surplus of gas caused by increasing gas prices would cause a reduction in price and/or a slow-down in production. TP clauses, however, function as a type of guaranteed market by maintaining more or less constant demand at the wellhead, regardless of end-use demand. Thus, producers are effectively shielded from market signals by take-or-pay clauses.

Pipelines themselves have attempted to devise a solution to the problems created when they take gas for which they have no existing market. One of these is off-system sales. Since 1980, the Commission has received over 65 applications for certificates of public convenience and necessity for authority to make off-system sales. Almost every pipeline applicant has justified its request for authority to make the off-system sales, at least in part, on the threat of significant TP liabilities caused by the absence of a market for the gas among the pipeline's system supply customers. Off-system sales however, do not correct the basic problems caused by TP provisions. Instead, they raise additional questions which have prompted further inquiry by the Commission.

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[8] NGPA Section 2(22) defines the term "deliver" to mean "physical delivery from the seller."

To summarize the kinds of injury now being caused by the TP contracting practice, the foregoing discussion makes these points:

- TP provisions distort pipeline purchase patterns, denying them the ability to buy gas on a least cost basis;
- TP provisions lead to larger investments in pipeline facilities, inflating pipeline rate bases and increasing depreciation expense;
- TP provisions force pipelines to make huge prepayments, thereby inflating rate bases and increasing wholesale rates;
- TP provisions can easily result in the forfeiture of gas for which consumers have already paid;
- TP provisions insulate gas producers from market realities and maintain prices at artifically high levels;
- TP make-up provisions operate to provide producer-sellers with unit revenues in excess of the maximum lawful prices which are allowed by NGPA only for gas physically delivered; and,
- TP provisions inspire off-system sales, raising additional issues which are the subject of a pending Commission inquiry.

In light of the EIA and NARUC studies and those issued by the two national gas industry associations, there can be little doubt but that indefinite price escalators and take-or-pay contract provisions are the major factors contributing to present and future market disorders. The evidence is overwhelming that these contract provisions create gas prices which have caused and will continue to cause widespread injury to the public, to pipelines and distributors and to the nation's economy. If the Commission intends to address problems causing market disorder in the natural gas industry, it cannot fail to deal with these two kinds of contract provisions.

II. THE COMMISSION POSSESSES AMPLE AUTHORITY UNDER THE NGA AND NGPA TO RESOLVE THE CONTRACTS PROBLEM

For the reasons explained in the portion of these comments immediately following, FERC has ample legal authority to resolve on a prospective basis the market disordering problems arising from the contract provisions and contracting practices discussed above. Before outlining the specific nature and source of that authority, it is important to comment on the relationship of this proceeding to the federal legislative process.

There have been numerous proposals for federal legislation to resolve various problems arising under the NGPA, including some of the market disorders to which the instant Notice of Inquiry is addressed. Those proposals are essentially irrelevant here. The fact that Congressional hearings have been conducted with reference to some portion of the problems created by gas sales contracts is no reason for the Commission to delay or avoid the use of its regulatory authority to deal with these issues. Similarly, the fact that the problems now present in the natural gas industry may not be the problems foreseen by the framers of the Natural Gas Act or of the Natural Gas Policy Act is neither legally significant nor surprising. As an independent administrative agency equipped with both broad legislative/rulemaking powers to protect the public interest and the natural gas consumer and a staff with decades of experience in dealing with the operational nuances of the natural gas industry at all levels, FERC is uniquely able to understand and evaluate new and complex problems arising in the natural gas industry. The classic role of an administrative agency is that of fashioning sound, workable solutions to new problems arising within the industry over which its jurisdiction extends. The Federal Communications Commission did not decline to regulate the television and cable TV industries simply because its 1933 statutory authority was enacted prior to the development of video technology. The Federal Power Commission did not decline to regulate natural gas curtailments in the 1970's simply because its 1938 statutory mandate did not address the problems of a general, nationwide gas shortage. Likewise, this Commission is duty-bound to act on the basis of its present legal powers and its overriding responsibility to the public interest. It does not have the discretion to put aside problems over which it has regulatory jurisdiction simply because those problems are new and unanticipated by Congress or because it may regard a legislative solution as more satisfactory or appropriate.

For these reasons, and given the dimensions of the contracts-related market ordering problem now foreseeable, there is no reason to withhold a Commission response in this proceeding. Action now by the Commission to limit the prospective effects of IPE's and TP's could alleviate the pre-1985 injury resulting from TP provisions and avoid the destructive price spike caused by IPE's in 1985. Moreover, Commission action to resolve the contracts problem now would support the NGPA's goal of providing a reasonably smooth transition to partial decontrol of wellhead prices.

In the following sections of this memorandum, the Commission's powers under the NGA and NGPA to resolve the contracts problem will be discussed.

A. The Commission Has Broad NGA Powers To Limit The Operation Of Contract Terms Found Contrary To The Public Interest.

The NGA was enacted "to protect the interest of consumers in an adequate supply of gas and at reasonable rates." Florida Power & Light Co. v. FERC, 598 F.2d 370, 379 (5th Cir. 1979), cert. denied, 444 U.S. 1013 (1980). Under the NGA, "[i]t is the Commission's statutory duty to insure that the rates, charges and practices of natural gas companies are just and reasonable." United Gas Pipe Line Co. v. FERC, No. 79-3209, slip op. at 8690 (5th Cir. July 6, 1981). The NGA gives the Commission powers commensurate with its broad mandate:

> The Act was intended to create, through the exercise of the national power over interstate commerce, "an agency for regulating the wholesale distribution to public service companies of natural gas moving interstate"; [citation omitted]; it was for this purpose expected to "balanc[e] . . . the investor and the consumer interests." FPC v. Hope Natural Gas Co., supra, at 603. This Court has repeatedly held that the width of administrative authority must be measured in part by the purposes for which it was conferred; [citations omitted]. Surely the Commission's broad responsibilities therefore demand a generous construction of its statutory authority.

Permian Basin Area Rate Cases, 390 U.S. 747, 776 (1968).

The broad powers granted the Commission by the NGA include the power to override or limit the operation of contract terms if the Commission finds these terms to be contrary to the public interest:

> Our conclusion that the Natural Gas Act does not empower natural gas companies unilaterally to change their contracts fully promotes the purposes of the Act. By preserving the integrity of contracts, it permits the stability of supply arrangements which all agree is essential to the health of the natural gas industry . . . . On the other hand, denying to natural gas companies the power unilaterally to change their contracts in no way impairs the regulatory powers of the Commission, for the contracts remain fully subject to the paramount power of the Commission to modify them when necessary in the public interest. The Act thus affords a reasonable accommodation between the conflicting interests of contract stability on the one hand and public regulation on the other.

United Gas Pipe Line Co. v. Mobile Gas Service Corp., 350 U.S. 332, 344 (1956) (emphasis added).

The Commission's power to limit the operation of contract terms is expressly stated in Section 5(a) of the NGA; that section states as follows:

> *Whenever the Commission*, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, *shall find that any rate*, charge, or classification demanded, observed, charged, or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, *or* that any rule, regulation, *practice, or contract affecting such rate*, charge, or classification *is unjust, unreasonable*, unduly discriminatory, or preferential, *the Commission shall determine the just and reasonable* rate, charge, classification, rule, regulation, *practice, or contract to be thereafter observed and in force, and shall fix the same by order*. . . .

(Emphasis added.)

The Commission's exercise of its authority under Section 5(a) is a two-step process. First, the Commission must find that an existing condition is unjust, unreasonable, or unduly discriminatory. Second, having condemned the status quo in the first step, the Commission can *and must* prescribe a remedy for that condition. Each step requires the Commission to draw a legal conclusion; in step one, the illegality of an existing condition must be declared; in step two, the justness and reasonableness of the remedy must be found. *American Smelting & Refining Co. v. FPC*, 494 F.2d 925, 940-41 (D.C. Cir. 1974), *cert. denied*, 419 U.S. 882 (1974).

In addition to Section 5(a), the Commission may act under Section 4 of the NGA to limit contract terms contrary to the public interest. Section 4(a) requires all natural gas companies to give notice of new rates and charges by filing them with the Commission. When the Commission receives such a notice, it is permitted by Section 4(e), upon complaint or on its own motion: (1) to suspend the proposed rate schedule for a period not to exceed five months, after which the proposed rate becomes effective (subject to a refund obligation if the Commission has not yet approved it); and (2) "to enter upon a hearing concerning the lawfulness of such rate." After hearing, the Commission may "make such orders . . . as would be proper in a proceeding initiated after [the rate] had become effective."[9]

The Commission also has broad power under Section 7(e) of the NGA to impose certificate conditions to protect the public interest. Section 7(e) provides that:

> The Commission shall have the power to attach to the issuance of the certificate and to the exercise of the rights granted thereunder such reasonable terms and conditions as the public convenience and necessity may require.

While the Commission's powers under Sections 4, 5 and 7 alone are sufficient to support the limitation of contract clauses contrary to the public interest in individual cases, the Commission can also proceed generically under Section 16 of the NGA, which provides that:

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[9] In other words in a Section 4 proceeding, the Commission may make the same findings and impose the same kinds of remedies as under Section 5(a). United Gas Pipe Line Co. v. Mobile Gas Service Corp., 350 U.S. 332, 341-43 (1956).

> The Commission shall have power to perform any and all acts, and to prescribe, issue, make, amend, and rescind such orders, rules, and regulations as it may find necessary or appropriate to carry out the provisions of this act.

Section 16 "provides for implementation of the core sections" of the NGA. American Smelting & Refining Co. v. FPC, 494 F.2d 925, 933 (D.C. Cir. 1974), cert. denied, 419 U.S. 882 (1974). As such, it provides additional authority for the initiation of a generic proceeding to examine the practice of agreeing to the inclusion of IPE and TP clauses in interstate gas sales contracts.

In short, there is no question that the Commission has the power under the NGA to initiate proceedings to place reasonable limitations on the operation of contract clauses which it finds to be contrary to the public interest. The next section will examine the uses the Commission has made of this power.

B. The Commission Has Used Its Broad NGA Powers To Limit The Operation Of Contract Terms Found Contrary To The Public Interest.

As shown above, it has been clear for many years that the Commission's powers under the NGA permit it to override particular terms in the contracts of entities it regulates. "Although the Natural Gas Act is premised upon a continuing system of private contracting, [citation omitted], the Commission has plenary authority to limit or to proscribe contractual arrangements that contravene the relevant public interests." Permian Basin Area Rate Cases, 390 U.S. 747, 784 (1968). See also United Gas Pipe Line Co. v. Mobile Gas Service Corp., 350 U.S. 332, 344 (1956).

The Commission has exercised this power in a variety of situations. One such example is the Commission's imposition of conditions on certificates of public convenience and necessity. For example, in Florida Power & Light Co. v. FERC, 598 F.2d 370 (5th Cir. 1979), cert. denied, 444 U.S. 1013 (1980), the Commission imposed a certificate condition limiting the operation of a 1965 warranty contract between Amoco Production Company (Amoco) and Florida Power and Light Company (FP&L) which it had approved several years earlier. The contract for the sale of gas to be used as boiler fuel by FP&L had been performed pursuant to the Commission's approval until 1972, when Amoco found it necessary to apply for certificates of public convenience and necessity to transport gas from a new offshore field to an onshore pipeline terminal, where Amoco planned to have Florida Gas Transmission Company (FGT) transport it via existing FGT facilities to FP&L's facilities. The gas would then be sold by Amoco to FP&L under the warranty contract.

The Commission granted Amoco the certificates, but conditioned them so as to prohibit Amoco from using the gas to fulfill its obligations under the FP&L boiler fuel contract. It did so because there was at that time a natural gas shortage and the Commission regarded the use of gas as boiler fuel to be a "low priority" use. Amoco and FP&L appealed the imposition of the condition, claiming that since the Commission had previously approved the warranty contract in 1967 when it certificated FGT to transport Amoco's gas to FP&L, it could not condition the new certificates so as to prevent Amoco from using the offshore gas to fulfill the contract.

On review, the court held that the Commission had not, as a technical matter, amended or modified its original certificates, and that the condition in the new certificates was a reasonable exercise of the Commission's NGA powers:

> . . . [T]he Commission was not foreclosed from taking into account the gas shortage at the time the new certificates were issued 10 years later in 1977. Needless to say, public interests change from time to time. It seems, therefore, improper in a controlled industry to permit private parties to lock out such changes through contracts, albeit approved, which in effect prohibit that controlled industry from responding to those changing interests.

598 F.2d at 378. After examining the factual showing made by Amoco as to the difficulties it would have finding onshore gas supplies to fulfill its contractual obligations to FP&L, the Commission concluded that its showing was insufficient, as it could purchase gas, albeit at a higher cost, to meet its warranty obligation to FP&L. The court concluded:

> When applying the provisions of the Natural Gas Act, courts have consistently recognized that the Act gives the Commission broad authority to limit or proscribe contractual arrangements that contravene relevant public interests. [Citations omitted.]
>
> The imposition of conditions in this case by the Commission under 15 U.S.C.A. § 717f(e) must be held to be a reasonable accommodation between the conflicting contractual interests on one hand and public regulation on the other.

598 F.2d at 379.

Another example of the Commission's use of its power to limit the operation of contract terms is its imposition of end-use curtailment plans on interstate pipeline systems, regardless of the terms of individual contracts between pipelines and wholesale-distributor customers. In American Smelting & Refining Co. v. FPC, 494 F.2d 925 (D.C. Cir. 1974), cert. denied, 419 U.S. 882 (1974), numerous parties appealed the Commission's approval of an interim curtailment plan for the Southern Division System of El Paso Natural Gas Company (El Paso). The Commission had found in Opinion No. 634 that El Paso's existing tariff provisions required the complete cutoff of certain wholesale customers, including gas required for small commercial and residential uses, before other wholesale customers were curtailed at all. The Commission found these provisions to be in violation of NGA Sections 4 and 5 and adopted in their place an interim curtailment plan based on end-use priorities.

Several parties challenged this interim plan, inter alia, on the ground that it impermissibly disrupted contractual relations. They based this claim on the fact that some wholesale distributor-customers' contracts with El Paso specified firm service while other wholesale distributor-customers had bargained for service that was contractually subject to curtailment. The Commission's plan, on the other hand, curtailed all customers ratably regardless of their contract rights. The Court disposed of this argument summarily:

> The short answer to this argument is that the Commission is not bound by agreements among parties subject to its jurisdiction. Section 5(a) of the Act gives the Commissioner [sic] authority to override discriminatory contractual arrangements . . . . Having found that then existing curtailment procedures for El Paso's Southern Division were discriminatory, the Commission was authorized to promulgate substitute procedures. To the extent that the illegal curtailment plan was reflected in customer service contracts, such contracts were also superseded by the Commission's orders.

494 F.2d at 934. See also Louisiana v. FPC, 503 F.2d 844, 858 (5th Cir. 1974)("[I]f [the] FPC were restricted to curtailing on the basis of contract rights, contract rights would enjoy protection while human needs might be disregarded. Such a restriction would be inconsistent with the Commission's broad statutory authority to protect the public interest.").

American Smelting & Refining Co. v. FPC, supra, is in accord with the leading case on the Commission's power to override private contractual rights in imposing end-use curtailment plans on interstate pipeline systems, FPC v. Louisiana Power & Light Co., 406 U.S. 621 (1972). The principal question in this case was whether the FPC could curtail direct-sale deliveries in times of natural gas shortages. Louisiana Power and Light Company, a direct sale customer of United Gas Pipe Line Company (United), had challenged the FPC's imposition of an end-use curtailment plan on the United system that made no distinction between direct-sale and resale customers, claiming that the Commission was without jurisdiction to curtail its deliveries. The Court rejected the argument that direct-sale transactions were beyond the reach of the Commission's jurisdiction and, hence, its curtailment powers. In so doing, it also passed upon the contractual limitation question:

> *Amici* have argued that permitting the pipeline's tariff amendments to take effect despite contrary terms in existing contracts is inconsistent with our decision in *United Gas Pipe Line Co. v. Mobile Gas Service Corp.*, 350 U.S. 332 (1956). In that case, however, we dealt with an attempt by a pipeline *unilaterally* to effect a change in its contract terms by making a filing under § 4. In the present cause, the issue is whether the FPC, acting under the head of its transportation jurisdiction and its broad mandate under § 16, may order pipelines facing shortages to develop and submit rational curtailment arrangements. Our holding in *Mobile Gas Service Corp.* does not govern the decision of this issue since, as we observed in that case:
>
> > "[D]enying to natural gas companies the power unilaterally to change

> their contracts in no way impairs the regulatory powers of the Commission, for the contracts remain fully subject to the paramount power of the Commission to modify them when necessary in the public interest." 350 U.S., at 344.
>
> We conclude therefore that the FPC has the jurisdiction asserted here and that the Natural Gas Act fully authorizes the method chosen by the FPC for its exercise.

406 U.S. at 646-47. These curtailment cases leave no doubt that the Commission has plenary power to limit and even abrogate contract terms in pipeline customer contracts if it finds that the public interest so requires.

The Commission has also acted to limit contracting practices it has found to be contrary to the public interest by promulgating rules that simply proscribe the use of such clauses. In fact, the principal instance in which it has done so involved IPE clauses and the Commission's recognition of their power to trigger price increases injurious to gas consumers.

In Opinion No. 341, The Pure Oil Co., Docket No. G-17930, 25 F.P.C. 383 (1961), the Pure Oil Company (Pure), a natural gas producer, filed a rate increase under Section 4(e) based on favored-nation clauses in three contracts with El Paso Natural Gas Company (El Paso). The Commission, after suspending the filing, let the proposed rates go into effect, subject to refund, and set the case for hearing, inter alia, on the question of whether "the favored-nation provisions contained in the said contracts were void or voidable as contrary to the public interest." 25 F.P.C. at 385.

After considering the arguments of El Paso and its customers in favor of declaring the favored-nation clauses void and the opposing arguments of Pure, the Commission concluded:

> Considering all the circumstances, we are of the opinion that the two-party favored nation clauses in Pure's contracts with El Paso, and indefinite escalation clauses generally, are contrary to the public interest. From the beginning of Commission regulation of independent producers under the Phillips decision in 1954, the undesirable and injurious aspects of such escalation provisions generally have been forcibly impressed on us and proceedings were early instituted looking to the elimination of such provisions. And although the record in this case was made with special reference to Pure's two-party provisions, by reasonable implication it confirms our conclusion based upon our experience with other types of indefinite escalation provisions, that such provisions generally are contrary to the public interest.

25 F.P.C. at 388 (footnotes omitted). Rather than striking these clauses from the Pure-El Paso contracts, however, leaving them incomplete and possibly invalidating the contracts in their entirety, the Commission utilized its findings in the Pure proceeding to justify the promulgation of a general rule dealing with IPE clauses.

Issued concurrently with Opinion No. 341, Order No. 232 amended Section 154.93 of the Commission's regulations by adding a proviso implementing its findings in that opinion. Nonacceptability of Contracts Between Producers And Interstate Natural-Gas Companies Containing Certain Types Of Automatic Escalation And Favored Nation Clauses, Docket No. R-153, 25 F.P.C. 379 (1961). The Commission amended Order No. 232 in Order No. 232A, 25 F.P.C. 609 (1961) and in Order No. 242, Rejection Of Sales Contracts Containing Indefinite Escalation Clauses And Of Applications Relying Upon Such Contracts For Gas Supply, Docket No. R-203, 27 F.P.C. 339 (1962). In Order No. 242, the Commission noted:

> A number of parties contend that the promulgation of these regulations would be unlawful and beyond the powers granted to the Commission by the Natural Gas Act. We conclude, however, that sections 4, 5, and 7 of the Natural Gas Act contemplate that the Commission will refuse to approve contractual provisions found adverse to the public interest. Section 16 of the Act, of course, authorizes the Commission to issue rules and regulations of general applicability found necessary or appropriate to carry out the provisions of the Act.
>
> Protection of the public interest is the touchstone of our regulatory powers under the Natural Gas Act. The Commission's obligation under the Act to the natural gas companies, as one segment of the public whose interest is to be protected, does not compel it to acquiesce in the use of contracts which carry provisions incompatible with a scheme of effective rate regulation. To be sure, the proposed rule will have impact upon contractual practices which have been fairly widespread. But the real issue is not one of "freedom of contract"; the question is whether the rule is rationally related to a condition which requires correction if regulatory objectives embraced by the statute are to be achieved. See American Trucking Associations v. United States, 344 U.S. 298. In our view, the rule we adopt fully meets this test.

27 F.P.C. at 339-40 (emphasis added).

As amended, the proviso to Section 154.93 (which deals with rate schedules) stated:

> Provided, that in contracts executed on or after April 3, 1961, for the sale or transportation of natural gas subject to the jurisdiction of the Commission, any provision for a change of price other than the following provisions shall be inoperative and of no effect at law; . . . .

25 F.P.C. at 610. The regulation then enumerated a list of the permissible price-changing provisions.[10] The Commission's power to promulgate the proviso to Section 154.93 was upheld in Pan American Petroleum Corp. v. FPC, 352 F.2d 241 (10th Cir. 1965).

After the issuance of Order Nos. 232, 232A and 242, the Commission began to reject summarily contracts proffered for filing under Section 4(e) that contained impermissible escalation clauses. Producers that had proffered such contracts appealed the summary rejection of their filings, contending that the filings could be rejected only after an adversary proceeding. The Supreme Court upheld the summary rejection procedure in FPC v. Texaco, Inc., 377 U.S. 33 (1964):

> Natural gas companies that seek to enter the field with prearranged escalator clauses and the like have a built-in device for ready manipulation of rates upward. Protection of

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[10] In Order No. 329, Permissible Provisions For Price Changes In Independent Producer Rate Schedules-Liberalization, Docket No. R-298 (December 1, 1966), the Commission amended Section 154.93 to add "area rate" clauses to the list of permissible price-changing clauses.

> the consumer interests against that device may be best achieved if it is given at the very threshold of the enterprise. At least the Commission may so conclude; and the legislative history makes clear that its authority reaches that far.

377 U.S. at 42-43 (footnote omitted).[11]

The Commission has also exercised its NGA powers to limit the operation of TP clauses, although in a more limited fashion. In Docket No. R-199, Non-Acceptability Of Contracts Between Independent Producers And Interstate Natural Gas Companies Containing Certain Provisions In Daily-Contract-Quantity And Take-Or-Pay-For Clauses, the Commission on May 22, 1961, issued a Notice Of Proposed Rulemaking proposing to limit certain provisions in rate schedules by prohibiting the use of specified daily-contract-quantity and make-up provisions in interstate gas sales contracts. This rulemaking was initiated to alleviate the potential economic dangers posed by the fact that many pipelines had made large monetary prepayments to producers for gas they could not take.

After considering the comments received, the Commission issued Order No. 334, 37 F.P.C. 110 (1967). In Order No. 334, the Commission found that the prepayment situation had eased greatly since the time of its Notice of Proposed Rulemaking, obviating the need for a general limitation on TP clauses similar to that imposed by Section 154.93 on IPE clauses. It did, however, promulgate a regulation requiring the make-up period in TP clauses in interstate gas purchase contracts to be extended to a minimum of five years or, if less, the remaining term of the contract.

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[11] While the Commission's right to reject summarily nonconforming contracts was upheld in FPC v. Texaco, supra, the Commission eventually adopted the practice of accepting contracts with impermissible clauses for filing with a standard waiver of § 154.93, that noted that clauses impermissible under the regulations would be inoperative to the extent they exceeded the scope of permissible clauses. Thus, many contracts in the Commission's files contain broad IPE clauses.

Order No. 334, as amended by Order No. 334A, 37 F.P.C. 587 (1967), added Section 154.103 to the Commission's regulations:

> 154.103 Limitations on provisions in rate schedules relating to make-up period for taking prepaid gas.
>
> Contracts for the transportation or sale of natural gas, subject to the jurisdiction of the Commission, executed after February 1, 1967, will be rejected if they contain provisions precluding buyer from receiving gas paid for but not taken at any time during a period of at least five years immediately following payment for such gas not taken, subject to contract provisions to protect against drainage. If the contract terminates before the end of the minimum five-year make-up period, a shorter make-up period, consistent with the time remaining under the contract will be permitted.

The Commission has enforced this regulation, requiring the amendment and refiling of nonconforming contracts. See Exxon Corp., Docket Nos. CI78-758 et al., Order Requiring Filing Of Contract Amendments (issued February 9, 1981), 14 FERC ¶ 61,114, reh'g denied, 15 FERC ¶ 61,179.

In sum, the Commission clearly has the power under the NGA and, as will be discussed below, under the NGPA, to limit the operation of clauses in interstate gas sales contracts if it perceives their operation to be inimical to the public interest. The Commission has used its contract revision power in many different contexts and its actions have been upheld upon court review. This power has been found to exist by reason of (a) the Commission's NGA Section 5 authority to reform contracts which affect the rates of natural gas companies, (b) the Commission's NGA Section 7 certificate authority (which remains intact with respect to interstate pipelines and all producers selling "flowing gas"), (c) its NGA Section 1(b) interstate transportation jurisdiction (which was held sufficient to justify Commission action requiring changes in contracts between interstate pipelines and other parties over which the Commission lacks jurisdiction) and (d) its NGA jurisdiction over natural gas producer sales for resale in interstate commerce (which, again, continues to exist with respect to flowing gas sales). Moreover, the Commission has previously recognized the potential threat to the public interest posed by IPE and TP clauses and moved to limit their operation to avoid such a threat. The passage of the NGPA and events since its passage now threaten to create a new problem with IPE and TP clauses that will dwarf the Commission's previous concerns with these clauses.

C. The Commission's Powers To Limit The Operation Of Contract Provisions Found Contrary To The Public Interest Retain Their Full Force Under The NGPA

Although the NGPA reduced the Commission's jurisdiction over natural gas producers and wellhead prices, its powers to limit the operation of contracts harmful to the public interest have not been affected by the NGPA. In fact, as a result of certain additional powers granted to the Commission under Title I of the NGPA, its authority over contracts and contract practices affecting rates has been strengthened. To define the present state of the Commission's authority over contracts, it is necessary to examine the effect of the NGPA on the Commission's broader powers over the transportation and sale of natural gas in interstate commerce.

The NGPA was enacted to rectify certain specific problems that the NGA regulatory structure was unable to resolve. Congress recognized that price disparities between the regulated interstate market and the unregulated intrastate market were distorting the allocation of available gas supplies and that regulated prices for interstate gas tended to discourage exploration and development of new supplies. NOI at 8. Congress, therefore, enacted the NGPA which both curtails and expands the Commission's powers under the NGA. As the court stated in Tenneco Inc. v. Sutton, 530 F. Supp. 411, 419 (M.D. La. 1981):

> The NGPA is basically an overlay of the NGA since the NGA remains applicable to interstate transportation and interstate sales for resale, unless a specific exclusion of the NGA jurisdiction is provided.

In other words, the NGPA modifies the Commission's NGA jurisdiction to the extent, and only to the extent, necessary to increase incentives for gas exploration and production and to integrate the interstate and intrastate gas markets. _Id_. at 418-19.

Title VI of the NGPA defines the effect of that Act on the Commission's jurisdiction with respect to producer and pipeline sales and transportation of natural gas. The principal modifications of the NGA are in the area of producer rate regulation. Section 601, entitled "Coordination with the Natural Gas Act," spells out the modifications of the Commission's NGA jurisdiction over transportation and sales of natural gas.

Section 601(a)(1), subtitled "Sales," removes certain types of gas sales from the jurisdiction of the Commission. Section 601(a)(1)(A) provides that the Commission's NGA Section 1(b) authority over sales for resale shall not apply _solely_ by reason of any first sale of gas which was not committed or dedicated to interstate commerce on November 8, 1978. Section 601(a)(1)(B) provides that the Commission's jurisdiction under Section 1(b) of the NGA shall not apply _solely_ by reason of any first sale of gas which _was_ dedicated to interstate commerce on November 8, 1978 if the gas fits the categories defined in Sections 107(c)(1)-(4)

(deregulated high-cost gas), 102(c)(new gas), or 103(c)(new onshore production gas). By use of the word "solely," Congress made it clear that the Commission retains jurisdiction over sales of all other gas which was committed or dedicated to interstate commerce on November 8, 1978.

Section 601(a)(1), therefore, permits a person to make a first sale of gas defined in subsections (a)(1)(A) and (B) without subjecting itself to the Commission's NGA jurisdiction over rates or service (including abandonment) solely by reason of such a sale. Moreover, as provided in Sections 601(a)(1)(D), any person engaging in such sales under (A) or (B) shall not be subject to regulation as a "natural gas company," as defined under the NGA solely by reason of any such sales. Conversely, to the extent that producers and pipelines engage in sales for resale other than those defined in Section 601(a)(1), the Commission retains its NGPA jurisdiction over those companies and those sales, subject to any specific limitations provided in any other sections of the NGPA.

Section 601(a)(2), subtitled "Transportation," removes certain limited transportation activities from the Commission's jurisdiction. That section provides that the Commission will not have jurisdiction over any transportation of any natural gas or any company engaging in transportation authorized under Sections 302, 303, or 311 of the NGPA. Except in these very specific instances, the Commission's NGA Section 1(b) jurisdiction over transportation of natural gas in interstate commerce and pipelines engaging in such transportation remains untouched by the NGPA.

Sections 601(b) and (c) establish certain specific limitations upon the Commission's NGA Sections 4 and 5 authority over rates and contracts affecting rates. Section 601(b)(1)(A) provides that any amount paid in any first sale of natural gas will be just and reasonable if it (1) does not exceed the applicable NGPA maximum lawful price (MLP) or (2) there is no MLP because the gas is deregulated pursuant to Title I of the NGA. Section 601(c)(2) permits automatic passthrough of an interstate pipeline's purchased gas costs to its customers under Sections 4 and 5 of the NGA if the "amount paid" is "just and reasonable" under Section 601(b)(1)(A), except to the extent that the amount paid is excessive due to "fraud, abuse, or similar grounds." The Commission's powers under Sections 4 and 5 of the NGA are otherwise left untouched.12/

12/ Section 601(c)(1) also imposes a limitation on the Commission's certificate authority under Section 7 of the NGA. Section 601(c)(1) provides that:

> The Commission may not deny, or condition the grant of, any certificate under Section 7 of the Natural Gas Act based upon the amount paid in any sale of natural gas, if such amount is deemed to be just and reasonable under Subsection (b) of this section.

This subsection, therefore, limits the Commission's power to impose a condition upon a certificate solely on the basis of the "amount paid" for gas sales subject to the Commission's certificate authority. This subsection does not deprive the Commission of authority to deny, or condition the grant of,

[Footnote continued on next page.]

Specifically, the Commission's powers over contracts and practices affecting rates under Section 5(a) of the NGA retain their full force with respect to pipelines and producers subject to the Commission's jurisdiction under Section 1(b) of the NGA. Accordingly, the Commission's Section 5 powers give it full authority over producer and pipeline contracts to the extent that: (1) the producer and pipeline rates are subject to the Commission's jurisdiction; (2) the contracts in question affect the rates to be charged; and (3) the Commission's action with respect to rates, contracts and practices affecting rates is prospective in effect and thus does not affect an "amount paid."

The Commission has jurisdiction over all pipeline rates applicable to sales for resale, and the Commission continues to have jurisdiction over producer rates with respect to sales governed by Sections 104, 106(a), 107(c)(5), 108 and 109 of the NGPA. Producer/pipeline contracts for gas within these categories directly affect rates of "natural gas companies" within the Commission's jurisdiction. Accordingly, the Commission's NGA Section 5 power to impose prospective revisions in contracts affecting the rates of a natural gas company extends to both parties--

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[Footnote continued from previous page.]

any certificate if the Commission finds that the gas sales contracts before it contain provisions which would cause serious injury to the market of the pipeline seeking the authority or would seriously jeopardize the financial soundness of the facilities for which the pipeline seeks certificate authority or the financial integrity of the pipeline company itself.

producer/seller and interstate pipeline/buyer--in the case of the wellhead sales contracts, where the gas is sold pursuant to NGPA Sections 104, 106(a), 107(c)(5), 108 and 109. The mere fact that the NGPA prescribes ceiling prices for first sales under most of these Sections (all but Section 107(c)(5)) does not deprive the Commission of its NGA Section 5 authority to prescribe contract revisions which effect rate reductions on a prospective basis. That power is explicit in NGA Section 5 and, so long as it is exercised on a prospective-only basis, it does not offend the NGPA Section 601(c) passthrough guarantee covering amounts paid (which obviously looks to past events, not to amounts payable in the future). Similarly, the fact that the Commission is given the discretion to increase ceiling rates applicable under NGPA Sections 104, 106(a), 107(c)(5) and 109 does not deny it the NGA Section 5 power prospectively to lower rates for sales under these NGPA Sections. Again, the only NGPA limitation on NGA Section 5 authority is that which affects past charges or amounts paid. See NGPA Sections 601(b)(1)(A) and 601(c)(2).

The crucial question remaining is whether the Commission's NGA Section 5 power to adjudicate and revise contract provisions extends to pipeline-producer wellhead sales contracts wherein the producer-seller's activity is exempt from FERC jurisdiction according to NGPA Section 601(a)(1). This includes contracts for gas sales which fall in NGPA Sections 102(c), 103(c) and 107(c)

(1)-(4). This question is answered in the affirmative for these reasons.

First, the Commission's NGA Section 5 power prospectively to revise contracts affecting the rates of "natural gas companies" or interstate pipelines does not depend on its having jurisdiction over both parties to such contracts. The jurisdictional prerequisites stated in NGA Section 5 are (a) that the Commission's findings regarding contract provisions must come "after a hearing", and (b) the contracts in question must affect a rate, charge or classification of a natural gas company. As discussed earlier, the Commission's authority to require contract revisions in implementing curtailment policy directly influenced contractual agreements between interstate pipelines and other parties (gas distributors and direct sale customers) over which the Commission lacked any regulatory jurisdiction.

Second, the NGPA references to NGA Section 5 found in NGPA Title VI refer to the "amount paid" under certain transactions as either being deemed just and reasonable (NGPA Section 601(b)) or being subject to guaranteed passthrough (NGPA Section 601(c)).13/ The choice of the phrase "amount paid" is a

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13/ Because of the prospective effect of the Commission's action under Section 5, the question of the proper interpretation of the terms "fraud, abuse, or similar grounds" under Section 601(c) need not be reached. The question could be reached if the Commission were to determine in a Section 4 case that amounts already paid for gas were excessive as a result of take-or-pay provisions which, either by themselves or as a result of actions taken by a pipeline pursuant to such provisions, constitute an abuse under Section 601(c).

significant one. That phrase on its face refers to a past event, i.e., a payment already made for natural gas in a first sale. Clearly, NGPA Title VI means that such a payment may not be undone (with refunds ordered) by this Commission pursuant to its ratemaking jurisdiction under NGA Sections 4 and 5 in the absence of "fraud, abuse or similar grounds." But the lack of authority to grant retroactive or retrospective relief with respect to NGPA first sales does not impair the Commission's NGA Section 5 authority to order prospective revisions in contracts which affect rates of natural gas companies. If Congress had intended to deprive the Commission of its NGA Section 5 remedial power with respect to pipeline contracts for gas supply, it could easily have used words other than "the amount paid." If the phrase "or agreed to be paid" or the phrase "or payable" had been added to the term "amount paid," it might then follow that the NGA Section 5 contract revision authority had been limited by NGPA to revisions which do not affect the gas sales price or revenue. But to interpret the phrase "amount paid" as depriving the Commission of its NGA Section 5 power to impose prospective contract revisions would be to give NGPA Section 601 a meaning beyond that which its words possess in their ordinary usage, would be to violate the principle of statutory construction articulated in Tenneco Inc. v. Sutton, supra, and would be to adopt a statutory interpretation which frustrates the essential mission of this agency.

In short, the NGPA does not affect the Commission's NGA powers to declare a practice or contract affecting a natural gas company's rates unjust or unreasonable or to prescribe a just and reasonable remedy, if it finds that practice or contract to be contrary to the public interest. The Commission's mandate to protect the public interest is simply not affected by the NGPA.

D. The Commission Has Used Its NGA/NGPA Powers To Regulate Contracts Effectively In The Public Interest

The Commission's continued exercise of its powers to regulate contracts in the public interest under both the NGA and the NGPA is best exemplified in its tight sands incentive price rule. In Order No. 99, High-Cost Natural Gas Produced from Tight Formations, Docket No. RM79-76, Final Rule (August 15, 1980) and Order No. 99-A, Order Denying Rehearing and Clarifying Order No. 99, Docket No. RM79-76 (October 21, 1980), the Commission promulgated a regulation preventing natural gas producers from collecting the NGPA Section 107(c)(5) tight formation incentive price unless their contracts contained a pricing clause stating either a fixed price, a rate determined by operation of a fixed escalator, or a rate set by specifically referencing the Commission's incentive price authority under NGPA Section 107. Again, the Commission was concerned that IPE clauses would cause the incentive price to apply to all tight formation gas and thus operate as a windfall rather than an incentive to increase production of such gas.

Natural gas producers challenged the "negotiated contract price requirement" on the grounds, inter alia, that Congressional "approval" of standard IPE clauses in Sections 313(a) and 105(b)(3)(D) of the NGPA required the Commission to permit payment of Section 107 special incentive prices under standard IPE clauses.[14] In Pennzoil Co. v. FERC, 671 F.2d 119 (5th Cir. 1982) the United States Court of Appeals for the Fifth Circuit rejected this argument:

> Pennzoil and Shell contend that NGPA §§ 313(a) and 105(b)(3)(D) indicate congressional endorsement of the use of indefinite price escalator clauses in contracts for the sale of high cost gas, and that such endorsement precludes restriction on such use. Examination of these sections discloses that they do not reach as far as the challengers contend. Both prescribe limitations on the effect of indefinite price escalator clauses. Section 105(b)(3)(D) ensures that indefinite price escalator clauses do not operate to bring the price for sales under intrastate contracts over the price provided in NGPA § 102, 15 U.S.C. § 3312. [Citation omitted.] Section 313(a) ensures that high cost gas prices do not operate to trigger indefinite price esca-

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[14] Section 313(a) prevents IPE clauses in high-cost natural gas sales contracts from triggering IPE clauses in sales contracts for other categories of natural gas. Section 313(b) bars the use of prices paid for gas sold pursuant to an emergency order of the President under Sections 302(a), and 303(b), (c), (d) or (g) from triggering IPE clauses. Section 105(b) (3)(D) prevents IPE clauses in intrastate contracts from operating to raise intrastate prices to levels in excess of the applicable MLP under the NGPA.

> lator clauses applicable to gas other than high cost gas. Neither section affirmatively dictates effective operation of indefinite price escalator clauses in situations not specifically proscribed.

671 F.2d at 128 (footnote omitted)(emphasis supplied). Thus, the fact that Congress specified the effect to be given IPE clauses in the situations described in NGPA §§ 313(a) and (b) and Section 105(b)(3)(D) does not mean that Congress has given IPE clauses a "stamp of approval."

The negotiated contract price requirement imposed by the Commission in Order No. 99 was further attacked by producers as an abrogation of the private authority of producers and pipelines to set natural gas prices at any price not proscribed by law. This argument too was rejected by the Court:

> The requirement does not act to deny collection of a price for which the gas qualifies under controlling definitional criteria; rather, the history of its development shows clearly that it is itself a part of the definition of gas entitled to the special incentive price.

671 F.2d at 125.

The Court upheld the negotiated contract price requirement, holding that in limiting eligibility for the Section 107 price to gas sold pursuant to contracts containing only certain pricing provisions, the Commission was acting in a manner reasonably calculated to further its legitimate regulatory policy:

> FERC's insistence on clear and unequivocal indication of the necessity of the incentive price is not arbitrary but a rational inter-

> pretation of its statutory duty. Its definition in the negotiated contract price requirement of contractual terms manifesting that unambiguous intention reflects a reasoned determination of the extent to which private contracts could be relied upon in attainment of the regulatory objective. No more is required of it.

671 F.2d at 127-28.

The affirmance of Order No. 99 sends a clear signal that the passage of the NGPA did not abrogate the Commission's powers, be they NGA or NGPA powers, to regulate the terms of natural gas purchase contracts, when the goal of such regulation is not merely to set the price to be paid under the contract, but is insure that contracts and practices injurious to the public interest are not permitted. The Commission had feared that, without imposition of the negotiated contract price requirement, producers who did not need the additional incentive to produce gas from tight formations would receive incentive prices, compromising the purpose of Section 107. It so stated in its Interim Rule and Request for Further Comment in Docket No. RM79-76 issued on February 20, 1980:

> This requirement serves the purpose of insuring that the incentive maximum lawful price is extended as an incentive for the production of additional new tight formation gas, rather than just as a windfall to the sellers . . . . The Commission expects that purchasers will pay a higher price in return for increased production.
>
> . . . .
>
> The Commission must limit the application [sic] of the incentive ceiling to those contracts which specifically refer to it (or to the extent permitted under a fixed rate or a fixed escalator clause) because its pricing

> authority is limited to setting incentive prices "necessary" to encourage additional production.

Interim Rule at 35-36.

In sum, the Commission's tight sands rule affirmed by the court in Pennzoil indicates that the Commission continues to have authority to regulate contracts in the public interest. Moreover, it shows that the courts recognize the Commission's powers to impose contract conditions in the exercise of its NGPA Section 107 authority which indirectly affects prices to be paid for 107 gas. The court rejected arguments that the Commission's rule amounted to back door regulation and commended the Commission for a rule which "deftly incorporated the selective processes of the marketplace in a regulatory scheme intended to stimulate precisely those processes." 671 F.2d at 128. The Commission can also use its contract revision powers under the NGA to restore equilibrium in the gas industry by imposing limits on the operation of those IPE's and TP's largely responsible for the present and future market distortions in the industry.

III. THE COMMISSION SHOULD EXERCISE ITS NGA/NGPA POWERS IN A GENERAL RULEMAKING PROCEEDING

Although the Commission could exercise its powers to limit the operation of IPE and TP contract provisions on a case-by-case basis, such a procedure would be cumbersome, inefficient, and inequitable. Enormous amounts of time and resources would be consumed in individual cases while the effects of excessive TP clauses continue to disrupt gas markets and the January 1, 1985 effective date of most IPE's rapidly approaches without a solution to that problem.

The Commission clearly has the power to approach the contracts problem on a generic basis in a rulemaking proceeding. Such a proceeding would be governed by the standards and procedures of Section 5 of the NGA, including specifically the requirement of a hearing. As discussed above, the Commission took precisely this route when it first limited the effects of IPE's over twenty years ago by issuing Order Nos. 232, 232A, and 242. Although the Commission initiated its investigation of IPE's in an individual case, it issued orders of general applicability concurrently with its decision in the individual case. The Commission thereafter rejected summarily contracts proffered for filing under Section 4(e) that contained the impermissible IPE's. The courts upheld the Commission's power to promulgate the rule and its summary rejection procedure. (See pp. 35-36, supra; see also, Permian Basin Area Rate Cases, 390 U.S. at 781-84 (1968). Both the Commission's powers under Section 16 of the NGA and Section 501 of the NGPA permit it to proceed on a generic basis to implement powers granted to it separately under various sections of the two Acts.[15]

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[15] Section 501(a) of the NGPA provides that:

> The Commission . . . is authorized to perform any and all acts (including any

[Footnote continued on next page.]

The public interest demands a final resolution of questions regarding the Commission's authority and willingness to address the contracts problem well before January 1, 1985. The key conditions precedent to use of the Commission's Section 5 contract revision power already exist. The reports issued by the AGA, INGAA, NARUC, and EIA discussed above, together with facts presented in pipeline filings indicating the dimensions of today's TP problems, establish more than probable cause to believe that the current IPE and TP contract provisions and practices are unjust and unreasonable given their foreseeable effect on pipeline rates. The industry and the public need an early decision by the Commission to institute a rulemaking proceeding placing the public on notice of its intent to exercise its authority to investigate pipeline contracts and contracting practices and, if it finds them unjust and unreasonable, to fix proper contract provisions and practices by rule.

[Footnote continued from previous page.]

> appropriate enforcement activity), and to prescribe, issue, amend, and rescind such rules and orders as it may find necessary or appropriate to carry out its functions under this Act.

It should also be noted that the Commission's authority under Sections 104, 106, 107 and 109 of the NGPA provides specifically that the Commission may implement its just and reasonable rate prescription powers "by rule or order."

IV. THE PROPOSED INCREASE IN FLOWING GAS CEILING PRICES IS UNJUSTIFIED ON COST GROUNDS, WOULD YIELD NEGATIVE SUPPLY BENEFITS AND WOULD NOT ACHIEVE ITS STATED OBJECTIVE

For the reasons outlined above, the most significant and potentially productive feature of the instant NOI is the attention it focuses on existing contract provisions. At the same time, the most threatening and potentially destructive feature of the NOI is the proposal to increase the ceiling price of flowing gas, i.e., gas now being sold under NGPA Sections 104, 106(a) and 109. In the following portion of these comments, we outline several bases on which the Commission should abandon this proposal as having no public interest justification and being counterproductive in terms of the current needs and concerns of the nation's gas industry, its consumers and its already-troubled economy.

A. An Increase In Flowing Gas Price Ceilings Has No Cost Justification

There is no credible evidence that higher flowing gas ceiling prices are necessary or justified by cost considerations. In other words, there is no substantial basis for concluding that the gas producing industry is receiving inadequate compensation for gas sold in the flowing gas categories. Gas now being produced and sold under NGPA Sections 104, 106(a) and 109 is, by definition, gas from wells drilled prior to early 1977.[16/] This "flowing gas" production results from the continuing operation of older wells on which the exploration and development work, including drilling and equipping, has long since been completed. Because the largest share of the cost of flowing gas wells is in the form of "sunk costs", production from such wells remains commercially feasible as long as current operating revenues exceed current operating expenditures.

In dollar terms, current operating revenues from flowing gas range from a low of $.26 (for minimum rate production) to a high of $2.15 per MMBtu (for production from wells drilled during the 1975-76 biennium. If the cost of maintaining production from a flowing gas well exceeds the assigned flowing gas ceiling price, the producer-operator of that well is entitled to apply for and receive special relief from this Commission. The relief available, of course, is a special price high enough to allow production to continue on an economical basis. If the Commission's recent experience showed a long list of special relief requests in which large numbers of producers alleged the inability to recover operating costs at prevailing flowing gas ceiling prices, there might well be cause to question the adequacy of the

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[16/] Gas from wells drilled after either February 19, 1977 (in the case of onshore "production wells") or April 20, 1977 (in the case of "new onshore wells" or offshore wells) is generally sold pursuant to NGPA Sections 102, 103 or 107 which provide for ceiling prices substantially higher than those in NGPA Sections 104, 106 or 109.

rate ceilings prevailing under NGPA Sections 104, 106 or 109. But this is not the case. A review of FERC Notices during the current calendar year indicates that not a single such special relief situation has been presented to the Commission in the year 1982.

A tentative explanation for the absence of special relief applications filed by producers of flowing gas is found in NGPA Section 108. Under that provision, gas from many marginal wells qualifies as "stripper well" production and, as such, is automatically subject to a ceiling price of $3.25 or higher (under currently effective adjustments), without regard to operating costs, etc.

Another element of circumstantial cost evidence is at hand. The instant proposal for an upward revision in the "flowing gas" ceiling prices available under NGPA did not originate with the gas producing industry. The only general suggestions of this kind presented formally to FERC came from the Process Gas Consumer Group (a group of industrial gas users) and a group of fuel oil dealers known as the Northeast Coalition for Energy Equity (neither of these groups advanced a cost-based rationale in support of their proposal.) In other words, the gas producing industry as such has failed to petition the Commission for general, flowing gas rate relief for a period exceeding three-and-a-half years of operations under NGPA; if a showing that flowing gas prices were non-compensatory could have been made, surely the major oil and gas companies would have done so without being prompted by the Commission in this proceeding.

The Technical Report published by the Commission's Staff on June 3, 1982 offers nothing persuasive in terms of a cost basis for a revision of flowing gas ceiling prices. The cost presentations reflected in Tables I and II of that report are essentially irrelevant to any determination of new just and reasonable rate levels for NGPA Sections 104 and 106 which account for the bulk of all "flowing gas."

These two tables purport to depict the unit cost result derived by applying approved costing techniques to recent data such as 1980 or 1981 drilling costs, 1980 and 1981 productivity estimates, etc. An attempt is made in these tables to develop a cost-based just and reasonable rate that "might have been established by the Commission had the NGPA not been adopted" (see p. 12, Technical Report).

These cost studies are fundamentally inappropriate and unsuited to the purpose of developing new ceiling prices for flowing gas. The DCF costing methods followed in Opinion No. 770 and purportedly illustrated and updated in Tables I and II of the Staff Technical Report were used to estimate the current cost of finding and producing new natural gas reserves. They were not applied to measure the actual operating costs incurred with respect to flowing gas; they were used to develop a cost basis for a revised incentive price for gas newly found and discovered. In current context, these cost studies, at best, are comparable to the Congressionally-established incentive prices and deregulated prices permitted by NGPA Sections 102, 103 and 107 and made applicable to gas from new wells. They are plainly not comparable to or relevant to an evaluation of the rates applicable to gas flowing from wells with spud dates extending from 1976 back to the 1960's.

The most value gleaned from a superficial review of Tables I and II pertains to the calculations there shown for the years 1975 and 1976. These tables purport to show the unit cost results derived by using actual 1975 and 1976 data in place of the 1975 or 1976 estimates necessarily relied upon by the FPC in its Opinion No. 770. The results of Tables I and II confirm the conclusion suggested earlier, i.e., that rates for flowing gas are generally adequate. These tables indicate that a cost-based rate in the range of $1.19 to $2.46 would be appropriate for gas from wells drilled in the 1975-76 biennium. The prevailing rate for flowing gas of that vintage is now well above $2.00 and is in the high end of the cost-justified range as shown by the Technical Report.

B. An Increase In Flowing Gas Ceiling Prices Offers No Supply Benefits, Would Reduce New Supply Incentives And Would Be Beyond FERC Authority.

Another fundamental flaw in the proposal to increase the ceiling price of flowing gas is the complete absence of any "quid pro quo" as a result of this type of price adjustment. As the Commission knows, and as its experience under NGPA Section 107 teaches, the gas exploration and development effort is responsive to the price of new gas, not the revenue available from gas already flowing. It follows that the billions of additional costs borne by U.S. gas consumers if flowing gas prices were significantly increased and received by U.S. flowing gas producers would not be matched by any comparable increase in the level of gas exploration and development activity. Any increase at all in that activity would be largely coincidental. As rational investors, gas producers invest any funds generated internally based on the rewards expected from their new prospects.

It is no answer to say that the dollars paid for flowing gas (under a plan where such gas is sold under higher ceiling prices) will be paid by the consumer (or are now being paid) for whatever new gas is brought to market and sold pursuant to Sections 102, 103 or 107. Despite the imperfections or distortions in the present price structure, the gas consumer and the gas distributor are greatly advantaged when, as now, the reward for finding new gas exceeds that for producing older reserves. The new gas price inspires a continuing search for additional gas reserves to replace volumes currently consumed. These new reserves must be found to sustain utility service and to improve the generally low reserve life indices of the interstate pipelines. To remove the incentive feature inherent in the current pricing structure would be to forfeit a cornerstone in the nation's energy security system, i.e., a vintage pricing system which has supported a vigorous, record-setting search for new, domestic reserves of natural gas in the past three-plus years. If a multi-billion dollar increase in flowing gas prices were effective in causing a multi-billion dollar decrease in the rewards for finding new gas (as seems predictable), the Commission should expect and will be responsible for a dramatic decline in the level of gas exploration activity.

Finally, it is clear that a flowing gas ceiling price revision which eliminates the concept of vintage pricing would fundamentally alter the shape of the rate structure created by Congress in the NGPA. Since the outset of producer price regulation in the Permian case, the "two-price system" has been a basic element of the producer rate scheme. Whatever else Congress may have achieved in the NGPA, it is profoundly obvious that it did not remove the basic pricing distinction between new gas and gas already flowing. To interpret the Commission's power to increase flowing gas ceiling prices as authority to undo the old/new gas dichotomy is to assume the regulatory power to put asunder the essential framework of the rate structure ordained by Congress. The Commission's authority to adopt just and reasonable rates "within the meaning of the Natural Gas Act" surely does not extend that far.

C. An Increase In Flowing Gas Ceiling Prices Would Not Yield Competitive Parity Among Purchasers Of New Gas Reserves.

There is no basis for concluding that an increase in flowing gas ceiling prices will provide a solution to the "gas cushion" problems[17] described in the instant Notice of Inquiry. If there are legitimate fears that some purchasers with large supplies of older gas will outbid others for new gas because of their "cushion" advantage, these fears must be dissipated, indeed eliminated, by the pricing provisions to be found in contracts covering the sale of new, post-NGPA gas reserves. According to the studies undertaken on the subject,[18] most if not all the newer wellhead gas sales contracts contain pricing provisions which tie the seller's revenue to the NGPA ceiling prices (in the case of post-NGPA sales made at regulated prices) or to a price well in excess of the NGPA ceilings (in the case of deregulated sales). Because the Commission has so far declined to exercise its power to secure for itself the contracts from which these studies are derived, and because these studies come from responsible sources,

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17/ As indicated in its motion filed July 1, 1982, AGD questions the Commission's ability to undertake any useful definition of the "cushion problems" in the absence of substantially more data than are presently available. The instant discussion assumes, *arguendo*, the existence of the hypothetical cushion problems outlined in the April 28, 1982 Notice of Inquiry.

18/ See the AGA, INGAA and ZIA Studies cited *supra*, Part I of these Comments.

it has little choice but to accept these findings as valid, at least for now.

Given the generalization that all newer wellhead sales contracts provide for the highest price permissible to the seller, the notion that a general increase in flowing gas ceiling prices would place all buyers on an equal footing (in the purchase of new gas supplies) is fanciful. Data available from Form 15 reports by interstate pipelines show that no two interstate buyers have the same mix of flowing vs. new gas, no two interstate buyers have the same mix of the 16 categories of flowing gas and no two buyers have the same degree of price or cost exposure in their contracts for post-NGPA gas (which includes Section 102, 103 and 107 gas). Likewise, it is fair to assume that no two buyers have the same rights conferred by "market out" provisions. It follows that a leveling-out of the flowing gas ceiling price, or a standard upward revision of all 16 flowing gas price categories by the same increment would cause a different overall average cost increase for each gas purchaser (or pipeline). To place each purchaser on an "equal footing" insofar as its average cost of gas is concerned would require the Commission to adopt an extraordinarily complex, highly discriminatory pattern of flowing gas ceiling price adjustments responsive to the condition of each individual purchaser. An additional factor to be considered in this regard is that most pipelines have ongoing gas acquisition programs. Accordingly, a pipeline's supply mix is constantly changing from month to month as new reserves are added and any uniformity achieved via flowing gas ceiling price adjustments could disappear immediately.

Apart from the indicated variations in purchasers' gas supply mix, an equally impressive diversity is found in the competitive realities presented by the markets served by various purchasers. Some pipelines' customers sell gas in competition with No. 6 oil, some compete with propane, some with electricity or heat pumps, some with No. 2 oil, etc. Even if some degree of uniformity could be achieved in terms of average cost of purchased gas, the field purchasers (or pipelines) would remain in diverse competitive positions relative to new gas reserves because of their diverse markets. A purchaser selling against a more expensive alternate fuel may have an advantage over one which sells against a cheaper alternate fuel. A purchaser selling in a market remote from the production source may be at a competitive disadvantage with a purchaser selling in a less distant market (given normal transportation cost differentials and excluding all other factors).

In presenting its discussion of the cushion and potential problems relating thereto in the instant Notice of Inquiry, the Commission has directed attention to a purely non-cost basis or rationale upon which to prescribe just and reasonable ceiling prices for old or flowing natural gas. For the reasons given above, there are extraordinary practical problems connected with any effort to implement a plan to eliminate the cushion and place all purchasers on a competitive par insofar as the acquisition of new gas reserves is concerned. Even assuming the cushion problems can or will be adequately documented (which assumes the development of far more data than are now publicly available),[19] there is good reason to doubt whether the large number of factors which both account for and reflect the diversity within the gas industry could ever be integrated in a ruling or rate order which created competitive parity among all or most gas purchasers. For these reasons, and those recited earlier in these comments, the Commission should discard its proposal to raise the ceiling price of flowing gas. That proposal has no cost justification, threatens real injury to the gas supply situation and offers no real possibility of achieving competitive parity among gas purchasers.

D. Higher Ceiling Prices For Flowing Gas Would Create Serious Competitive Injury and Immediate Market Losses In East Coast Gas Utility Service Areas And Increase Oil Imports.

As the Commission knows, any increase in flowing gas ceiling prices will be reflected promptly, although not uniformly, in the average cost of gas of each interstate pipeline. This impact on gas prices would be caused by the operation of "area rate clauses" in most wellhead sales contracts covering flowing gas. By reason of PGA-type arrangements existing within the several states, these higher interstate pipeline rates will probably be reflected at various times and in various amounts, in the form of higher retail rates. As the Commission also knows, the effect of any significant increase in the average cost of pipeline gas or any substantial general increase in retail rates will change the competitive position of natural gas in a variety of situations and will cause a variety of types of injury to gas distributors, gas consumers and to the general public. The purpose of this portion of AGD's comments is to outline the nature of the injury predictable in the east coast gas utility service areas served by AGD companies.

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[19] See AGD's Motion For the Production of Additional Data Not Publicly Available, July 1, 1982 in this proceeding.

1. The Foreseeable Loss of Gas Sales is Significant

The first type of injury resulting from a significant increase in flowing gas prices is the gas utilities loss of sales revenues. AGD undertook a company-by-company survey in July 1982 to estimate the loss of gas sales by its members in the 14 states and the District of Columbia in which they annually sell from 1.5 to 2.0 trillion cubic feet of gas to some 11 million customers. This survey tested the market impact of a general increase in flowing gas prices using two alternate assumptions. In "scenario A," it was assumed that flowing gas ceiling prices would be increased to coincide with the ceiling price prevailing under NGPA Section 102. In "scenario B," it was assumed that the flowing gas price would be increased to $8.00 per MMBtu, a price level comprehended by a June 3, 1982 Technical Report issued by the Staff in this proceeding. With these two changes in the ceiling price regulations affecting flowing gas, AGD companies were provided with two restatements of their current pipeline wholesale rates reflecting the changes in pipeline purchased gas costs that would result from these two bases and, taking into account recent prices for alternate fuels in the various east coast areas served by these companies, each AGD company was asked to provide an estimate of the volume of currently-served load which would be lost.

Given this mid-1982 survey as a foundation, AGD can assert with conviction that an increase in the flowing gas ceiling price would aggravate current problems and create immediate and serious irreparable injury to its member companies and to the millions of gas consumers along the eastern seaboard. Among the facts which emerge from this survey are the following:

a. Sales to east coast customers with alternate fuel burning equipment (excluding sales for electric generation) would be reduced by nearly one-third (32.5 percent) if the flowing gas ceiling price is increased to coincide with the NGPA Section 102 price (scenario A) and by about three-quarters (75.5 percent) if the flowing gas price is increased to $8.00 (scenario B). The revenue loss sustained under scenario A from this one category of sales losses would be about $553 million[20/] per year; under scenario B, the revenue loss would be about $1.3 billion[21/].

[20/] Based on a load loss of 98,582 MMcf and an average retail price of $5.61 per Mcf.

[21/] Based on a load loss of 229,034 MMcf and an average retail price of $5.61 per Mcf.

b. Sales to east coast customers of all kinds would be reduced by about 9 percent under scenario A and by about 31.5 percent under scenario B. The total annual revenue lost to AGD companies would be about $864 million[22/] under scenario A and about $3 billion[23/] under scenario B.

c. The primary reason for the predicted sales losses is competition from No. 6 fuel oil. AGD's survey indicated that customers who can switch to No. 6 fuel oil account for some 77 percent of the total sales loss (136,297 MMcf) in scenario A.

d. Given the magnitude of load loss to No. 6 fuel oil, a massive increase in oil imports would be triggered. This would, in turn, exacerbate balance of payments, deficit, air pollution and national security problems at a time when the nation simply cannot afford such costs.

While the dramatic adverse impact on gas utilities is readily apparent from the survey data, the adverse consumer impact of these figures should also be recognized. The immediate sales losses triggered by a general increase in flowing gas prices will not merely cause a massive transfer of wealth from east coast consumers to flowing gas producers; these losses will also cause a massive shift of the economic burden of sustaining east coast gas utility service from the industrial consumers (many of which will leave that system on short notice) to the residential and small commercial consumers (most of which have no alternative but to remain as gas users). The significant share of the fixed costs of

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[22/] Based on load loss of 136,297 MMcf and an average retail price of $6.34 per Mcf.

[23/] Based on load loss of 484,587 MMcf and an average retail price of $6.34 per Mcf.

operating gas utility systems now absorbed or paid by larger consumers which can and will switch to other fuels will inevitably be imposed on the smaller customers who make up the "less elastic" portion of today's retail gas market. This reallocation of the fixed cost burden will itself have a market-chilling effect as residential customers become less attracted to natural gas and, over time, choose other fuels in its place. The many hundreds of millions in fixed charges now paid by larger, dual fuel customers will ultimately be borne by those which remain. This added economic burden is one which carries extraordinary adverse long-term consequences for the entire east coast economy, for the AGD companies and for the millions of consumers they are obligated to serve.

2. Competitive Injury to Gas Distributors and Their Customers Would Follow From Sales Losses

Turning to other kinds of injury resulting from a substantial increase in flowing gas prices, the relevant factors and kinds of injury are less readily measured than are sales losses, even though they are no less foreseeable. A primary concern of gas distributors, of course, is the loss of whatever competitive advantage may exist in any of its several market categories. The gas utility business relies heavily on its ability to expand its sales by increasing the number of customers, the usage per customer within a given geographic area, or by extending its mains into new areas to serve new customers. In these ways, a gas distributor can realize economies of scale, can expand its rate base, can improve its earnings and can discharge its utility obligation to provide reliable service to all who demand it. None of these objectives is attainable if natural gas is priced out of the market.

Where, as here, it is foreseeable that natural gas will be priced out of some of its long-standing markets in the east coast area, the gas distribution companies will be obliged to "cover" these market losses by increased rates to those customers who remain. The fixed charges necessary to maintain a company's operations will not decline to match the loss in sales. Accordingly, a significant degree of primary economic injury is foreseeable in the form of higher prices charged to those customers who remain after the sales losses are sustained. While any estimate of the dollar amount of this injury is highly speculative, the certainty of this type of injury is not. Even more serious, however, is the series of problems and the related injury which can be foreseen if the market losses threatened by the instant proposal develop into permanent economic realities within a given gas distributor's market area. If market losses are not offset by new sales within a reasonable period of time, a given gas distributor's competitive problems can be compounded as it increases rates again and again on a smaller and smaller "captive" customer base.

3. Secondary Injury to Gas Consumers and the Public is Certain to Follow Gas Sales Losses

In addition to the primary kinds of injury attributable directly and immediately from the loss of gas utility sales volumes, a long list of equally serious secondary impacts is foreseeable as a result of a general increase in the price of flowing gas. Some of these injuries are described in the following ways.

a. Increased gas utility overhead expense

History teaches that higher and higher retail prices for natural gas carry with them a number of increasing cost problems much less visible than the mere increase in the Btu cost of natural gas. When gas prices continue to escalate rapidly, as they would if flowing gas prices were to rise, a number of cost-intensive efforts are made necessary by gas utilities.

First, the number of customer complaints will predictably increase as consumers begin to devote larger portions of their income to their energy usage. This requires the deployment of larger numbers of customer-relations personnel, larger communications costs and increased administrative expense for all gas utilities affected by the general increase in price.

Second, the necessity for more frequent and more significant rate relief at the local level creates the likelihood of more intensive and more frequent rate case litigation expense. More consumers become more concerned with natural gas costs, more protest groups become organized, more legislative committees undertake oversight activities with respect to gas utility operations, etc. In response to these developments, more utilities find it necessary to employ more consultants, lawyers, public relations specialists and other highly paid professionals to defend and rationalize the need for increased gas rates.

Third, the need for more customer relations expense and the increase in rate litigation expense places a larger demand on the executive or management personnel of a gas utility. More senior personnel are required to manage a more diverse set of major corporate problems and expenditures. This, too, tends to increase utility operating expenses as a result of generally higher retail gas rates.

b. Negative growth presents extraordinary problems for utilities

The non-quantifiable, but foreseeable, negative impacts of a general increase in the cost of flowing gas (and, hence, further increases in the retail price of natural gas) include the serious costs associated with the acquisition of an image of negative growth on the part of a gas utility. If gas prices were to increase even more rapidly than the 20 percent-per-year pace experienced under NGPA, all the trends now being fought by gas utilities would become less manageable and more likely to become deep-seated, long-term problems. For example, the number of customers with installed alternate fuel-burning capacity is bound to increase more rapidly as gas costs increase more suddenly. This fact means that gas sales become increasingly vulnerable to changes in the price of alternate fuels, that gas sales revenues become less predictable and that the overall gas utility business becomes more risk-prone. Higher gas rates also mean that the number of new or "conversion" customers will decline more rapidly than otherwise. These customers, in many areas, are the market through which gas utilities are able to avoid net losses in total sales. As conservation causes a decline in sales to existing customers, the sale of "saved" or "conservation gas" to new customers frequently allows a gas utility to maintain a reasonably constant pattern of sales. As natural gas becomes more expensive, the opportunity to avoid sales attrition and take advantage of the cheap expansibility inherent in this era of higher conservation becomes less and less a reality.

As a result of these kinds of indirect, less dramatic factors causing losses in gas utility markets, there is an abiding threat to the survival of many gas utilities. When, as is threatened here, the retail cost of natural gas rises at a rate noticeably more rapid than the cost of most other essential items, there is the threat that the local gas utility will enter a negative growth cycle from which it has no real chance of escaping. When and if gas sales decline significantly, the gas utility has no choice but to raise its rates to recover its fixed charges. This action inevitably reinforces the sales decline, which leads to a further rate increase, etc. There is no sound way in which the Commission can know how close any particular gas utility is to this particular condition. What the Commission does know, however, is that the average wellhead cost of gas has climbed from about 75 cents in 1978 to the current level of $2.40 per MMBtu. It knows the average retail price for natural gas has more than doubled in many areas in the past three-plus years, approximating a one-third increase each year. Surely it must be obvious that the public's acceptance of the reality of higher natural gas prices has been severely reduced in the 1980's. In these circumstances, the wisdom of a general flowing gas rate increase for which there is no cost justification, no gas supply justification and no documented, "cushion"-based rationale is a rate increase which is not in the public interest and makes no common sense. The Commission ought to see that "enough is enough."

V. CONCLUSION

For the foregoing reasons, AGD respectfully submits that the instant proceeding should be used as a forum in which the Commission could address the extraordinary market ordering problems arising from the terms of producer-pipeline gas sales contracts. If that course is not followed, however, the Commission should nonetheless move promptly in this proceeding to abandon the proposal to increase the ceiling price of flowing gas as an idea replete with potential injury and offering no advantages and no benefits to the public, the industry or to the nation's economy.

Respectfully submitted,

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Their Attorneys

AGD MEMBER COMPANIES

Baltimore Gas & Electric Co.
Bay State Gas Co.
The Berkshire Gas Co.
Boston Gas Co.
The Brooklyn Union Gas Co.
Cape Cod Gas Co.
Central Hudson Gas & Electric Corp.
City of Bowman, Ga.
City of Buford, Ga.
City of Commerce, Ga.
City of Covington, Ga.
City of Elberton, Ga.
City of Hartwell, Ga.
City of Holyoke, Mass. Gas & Electric Dept.
City of Lawrenceville, Ga.
City of Madison, Ga.
City of Monroe, Ga.
City of Royston, Ga.
City of Social Circle, Ga.
City of Sugar Hill, Ga.
City of Toccoa, Ga.
City of Union Point, Ga.
City of Westfield Gas & Electric Light Dept.
City of Winder, Ga.
Commonwealth Gas Co.
Concord Natural Gas Corp.
The Connecticut Gas Co.
Consolidated Edison Company of New York, Inc.
Delmarva Power & Light Co.
Elizabethtown Gas Co.
Fitchburg Gas and Electric Light Co.
Gas Service, Inc.
Haverhill Gas Co.
Long Island Lighting Co.
Lowell Gas Co.
Lynchburg Gas Co.
Manchester Gas Co.
New Jersey Natural Gas Co.
New York State Electric and Gas Corp.
North Carolina Natural Gas Corp.
Northern Utilities, Inc.
Pennsylvania Gas & Water Co.
Pequot Gas Co.
Philadelphia Electric Co.
Philadelphia Gas Works
Providence Gas Co.
Public Service Company of North Carolina, Inc.
Public Service Electric & Gas
South County Gas Co.
South Jersey Gas Co.
The Southern Connecticut Gas Co.
UGI Corporation
Valley Gas Co.
Washington Gas Light Co.

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United States Senate
COMMITTEE ON
ENERGY AND NATURAL RESOURCES
WASHINGTON, D.C. 20510

January 3, 1983

Mr. C. William Cooper
United Distribution Companies
159 Town Hall Square
Falmouth, Maine 02540

Dear Mr. Cooper:

Attached are questions in follow-up to your appearance at the Committee's December 13, 1982 hearing on current conditions in the natural gas market. Please provide your responses to these questions to the Committee not later than the close of business January 17, 1983. If any clarification is needed you may contact Mr. Howard Useem (202-224-5205) of the Committee staff.

Sincerely,

James A. McClure

James A. McClure
Chairman

Enclosures

JAM:HU

QUESTIONS FROM REPUBLICAN MEMBERS OF THE COMMITTEE

1. United Distribution Companies' testimony (p. 1) states that studies that the UDC have commissioned indicate that pipeline gas purchase costs have reached and are being projected above market clearing levels.

   Q. In UDC's opinion, would any of the bills currently pending before the Committee */ fully address the problems in the natural gas market, or should Congress instead seek to be more comprehensive in its approach to the issue of natural gas?

2. In UDC's opinion, what impact would the various proposals currently pending before the Committee*/ have on:

   --residential, commercial and industrial gas prices?
   --short-term and long-term gas supplies?
   --the financial situation of producers, pipelines and gas distribution companies?

3. In UDC's opinion, to what extent and on what matters does the Federal Energy Regulatory Commission have the statutory authority to take action to address current and potential future problems in the gas market? Please provide the Committee with a detailed legal analysis of the FERC's authority. What actions would you recommend that the FERC take?

*/ S. 2074; S. 2892; S. 3028; S. 3054; S. 3069; S. 3070; S. 3076; S. 3088.

QUESTIONS FROM DEMOCRATIC MEMBERS OF THE COMMITTEE

QUESTIONS FOR UDC (BILL COOPER)

1. Have you analyzed the price freeze bills, and the take or pay revocation bills, which are pending before this Committee? Do you support them?

2. How soon would consumers feel any price relief, if the legislation were enacted by December 31?

Official Committee File

SENATE COMMITTEE ON
ENERGY AND NATURAL RESOURCES
RECEIVED
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C. WILLIAM COOPER
ATTORNEY-AT-LAW
159 TOWN HALL SQUARE
FALMOUTH, MASSACHUSETTS 02540
(617) 540-0330

January 14, 1983

Honorable James A. McClure, Chairman
Committee on Energy and Natural
Resources
United States Senate
Room 3106, Dirksen Senate Office Buidling
Washington, D.C. 20510

Dear Senator McClure:

In response to your letter of January 3, 1983, I submit in Appendix A hereto responses to the several questions which have been propounded to me as a result of my appearance at the Committee's December 13, 1982, hearing on current conditions in the natural gas market.

If any further information is required, please feel free to call upon me.

As stated at the hearing, we most earnestly urge that your Committee promptly hold hearings and recommend comprehensive legislation which will set this industry on a sound and operable economic course for the future.

Respectfully submitted,

William Cooper
C. William Cooper, Chairman
United Distribution Companies

CWC/sm

Enclosure

UNITED DISTRIBUTION COMPANIES

Responses to Questions
Transmitted by Chairman McClure's Letter of
January 3, 1983

A. "QUESTIONS FROM REPUBLICAN MEMBERS OF THE COMMITTEE."

1. "In UDC's opinion, would any of the bills currently pending before the Committee*/ fully address the problems in the natural gas market, or should Congress instead seek to be more comprehensive in its approach to the issue of natural gas?"

Prices for natural gas in the field are increasing as a result of contractual and institutional forces which are inimical to, and conflict with, a sound resource market. In these times of adequate supply and depressed markets, prices for this natural resource should be falling, but, instead, they are inexorably rising. In short, field prices are not responding to those economic forces which should dictate their course.

This is the fundamental problem of the natural gas market and, in UDC's opinion, it stems from four causes:

a. contractual provisions in producer-pipeline contracts which cause field prices to ratchet upward with NGPA ceiling prices, whereas contract prices should be trending downward;

b. excessive take-or-pay requirements in producer-pipeline contracts which cause uneconomic, preferential and wasteful taking of high priced supplies of gas when lower priced supplies are available;

c. indefinite price redetermination provisions in producer-pipeline contracts which will ratchet field prices up and up inexorably, to unmarketable levels, in defiance of normal market forces; and

d. provisions in existing pipeline rates which frustrate the transmission of normal market signals from utility service back through interstate pipelines to the field--in short, the demand/price limits of utility service are not made apparent to producers and pipelines--; yet these limits must control and limit field prices or the natural gas market will not work.

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*/ S. 2074; S. 2892; S. 3028; S. 3054; S. 3069; S. 3070; S. 3076 S. 3088.

In UDC's opinion, the natural gas market will be placed on a sound and operable course only if and when Congress legislates comprehensively in all four of the above areas.

None of the above cited Bills filed during the 97th Congress would have achieved all of these necessary market corrections. Clearly, these overall corrections would not be accomplished through the deregulation and upward price ratcheting course proposed by Senator Johnston in S. 2074--indeed, those actions would only aggrevate what is already a crisis situation in which natural gas is pricing itself out of the market. And, all other cited Bills are limited to one or two of the above problems. None deal with all four and, unfortunately, none deal with pipeline-distributor relationships--an integral element of the overal situation.

It is, respectfully, urged, therefore, that your Committee expeditiously deal with all aspects of the situation and recommend to Congress comprehensive legislation dealing with all four of the problems outlined above.

2. "In UDC's opinion, what impact would the various proposals currently pending before the Committee*/ have on:

--residential, commercial and industrial gas prices?
--short-term and long-term gas supplies?
--the financial situation of producers, pipelines and gas distribution companies?"

S. 2074 would undoubtedly raise prices to all classes of customers. While that Bill would normally be considered an encouragement to supply, further contraction of the market through additional price increases would undoubtedly discourage drilling for gas, since there would be no market outlet. The foregoing effects of the Bill would discourage financing in all segments of the industry.

Those of the cited Bills which propose price freezes would provide temporary relief from the current upward climb of prices, but this alone does not answer the underlying long term problems of the industry. And, if a price freeze were maintained for too long, it would choke off supplies and injure the financial situation of all aspects of the industry. Other legislative solutions are required.

This same deficiency is inherent in all other of the cited Bills. While dealing with one or more problems, they do not attack all.

3. "In UDC's opinion, to what extent and on what matters does the Federal Energy Regulatory Commission have the statutory authority to take action to address current and potential future problems in the gas market? Please provide the Committee with a detailed legal analysis of the FERC's authority. What actions would you recommend that the FERC take?"

We have cited above four critical problems, three involving problems with producer-pipeline contracts for first sales of natural gas and the fourth dealing with pipeline distributor relationships.

a. Producer-pipeline contract problems.

Whether the Federal Energy Regulatory Commission ("Commission") has authority under Sections 4 and 5 of the Natural Gas Act to abrogate or modify the harmful provisions in producer-pipeline contracts is a hotly debated subject on which there are no judicial precedents and on which expert counsel vigorously differ.

While counsel to UDC hold personal views in favor of authority, we refrain from submitting the same because we believe Congress cannot afford to set its course on the strength of such opinions in this doubtful area of law. There is a major crisis which must be solved; and sure and certain means must be taken to this end. It would be a sad disservice on our part to urge that Congress refrain from acting on the strength of a debatable opinion as to the Commission's authority to deal with the subject, for ultimate Court decisions might run to the contrary, and the public service could be irreparably harmed.

We submit that, in the face of doubtful authority, Congress must act, for the public interest warrants and demands a clear and certain solution.

b. Pipeline-distributor relationships.

In the matter of pipeline and distribution relationships, the Commission does have adequate authority under the Natural Gas Act to deal with pipeline rate designs on a case-by-case basis and it has limited authority to this end in rulemaking proceedings. But, again, it is of critical importance that the Commission act both quickly and with certainty as to sound public policy, for the prompt placing in effect of new market signal mechanisms is a key to sound market operations. In the public interest, Congress must determine policy and mandate prompt Commission action in accordance therewith.

B. "QUESTIONS FROM DEMOCRATIC MEMBERS OF THE COMMITTEE."

1. "Have you analyzed the price freeze bills, and the take-or-pay revocation bills, which are pending before this Committee? Do you support them?"

UDC supports the concept that prices are rising too rapidly and that action must be taken in this regard. We also support the concept that excessive take-or-pay requirements must be limited.

But, UDC does not support the cited Bills as such, for three reasons:

a. We believe there must be comprehensive legislation attacking four major problems in coordinated fashion and not piece-meal solutions;

b. We recommend that current price levels should be corrected through means other than a price freeze as such; and

c. We believe that take-or-pay requirements should be reduced rather than revoked. Within proper limits, take-or-pay is a sound and reasonable contractual practice.

2. "How soon would consumers feel any price relief, if the legislation were enacted by December 31?"

Those of the cited Bills before the 97th Congress which envisioned emergency relief for this winter would have failed in that result had they been enacted. Administrative process under the Natural Gas Act and state utility laws necessarily impose considerable delay between alternations in field prices as such and successive reflections of these events in pipeline and distribution utility rates. Had the statutes been enacted prior to December 31st, reductions in utility rates would not have occurred until well into the spring of this year.

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D. MICHAEL HARVEY, CHIEF COUNSEL FOR THE MINORITY

United States Senate
COMMITTEE ON
ENERGY AND NATURAL RESOURCES
WASHINGTON, D.C. 20510

January 3, 1983

Mr. Jack Elam
Process Gas Consumers Group
Suite 800/1666 K Street, N.W.
Washington, D.C. 20006

Dear Mr. Elam:

Attached are questions in follow-up to your appearance at the Committee's December 13, 1982 hearing on current conditions in the natural gas market. Please provide your responses to these questions to the Committee not later than the close of business January 17, 1983. If any clarification is needed you may contact Mr. Howard Useem (202-224-5205) of the Committee staff.

Sincerely,

James A. McClure

James A. McClure
Chairman

Enclosures

JAM:HU

QUESTIONS FROM REPUBLICAN MEMBERS OF THE COMMITTEE

1. In the Process Gas Consumer's opinion, what impact would the various proposals currently pending before the Committee*/ have on:

   --residential, commercial and industrial gas prices?
   --short-term and long-term gas supplies?
   --the financial situation of producers, pipelines and gas distribution companies?

2. In PGC's opinion, to what extent and on what matters does the Federal Energy Regulatory Commission have the statutory authority to take action to address current and potential future problems in the gas market? Please provide the Committee with a detailed legal analysis of the FERC's authority. What actions would you recommend that the FERC take?

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*/ S. 2074; S. 2892; S. 3028; S. 3054; S. 3069; S. 3070; S. 3076; S. 3088.

QUESTIONS FROM DEMOCRATIC MEMBERS OF THE COMMITTEE

QUESTIONS FOR PGC (Jack Elam)

1. Your legislative prescription calls for voluntary renegotiation to resolve "the contract problem." Will it work? How soon? How can we monitor contract renogotiation progress? What if progress isn't being made--what should we do?

2. Your statement says (on page 22) that average wellhead prices will "settle" (after deregulation) at whatever volume is needed to sell the gas. If Congress does nothing to defuse indefinite price escalators, how will that work? Which prices would come down? How?

PGC
PROCESS GAS CONSUMERS GROUP • SUITE 800/1666 K STREET, N.W.
WASHINGTON, D.C. 20006
202 872-9349

BY HAND

January 21, 1983

The Honorable James A. McClure
Committee on Energy and Natural Resources
3104 Dirksen Senate Office Building
Washington, D.C. 20510

Re: Natural Gas Markets

Dear Senator McClure:

Enclosed are the Process Gas Consumers Group's responses to the questions submitted to us by the Committee in follow-up to our testimony at the December 13, 1982 hearing on current conditions in the natural gas market.

We appreciate this opportunity to supplement our views and will be pleased to discuss these matters further with the members and staff of your Committee.

Sincerely,

Jack Elam

Jack Elam
Chairman

PGC
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202 887-3425

PGC Response to Senate Republican Question No. 1

The provisions of the various bills that were pending before the Committee in the last Congress may be grouped for convenience in three general categories: (1) comprehensive NGPA reform; (2) wellhead price freeze and extension of controls; and (3) relief from pipeline/producer contract terms. PGC believes that the impact of the latter two types of proposals (either alone or in combination) on the gas markets would be significantly adverse and that they should be rejected in favor of legislation which deals with the NGPA in a more comprehensive and long-term fashion.

I. The first category of bills (*i.e.*, comprehensive NGPA reform) includes S. 2074, introduced in February 1982 by Senator Johnston. With the exception of certain problems discussed below, PGC believes that S. 2074 represents a reasonable and workable compromise for eliminating the serious price, supply, and financial problems arising under the NGPA. Although there are provisions of this bill which we would prefer be modified, we believe that it is the only one of the various proposals *currently pending* which has the potential to restore stability to the gas market. The bill's provision for phased, but full, decontrol of wellhead prices promises that such prices will be more stable -- and likely lower -- than would be the case under the NGPA. By moving *toward* free-market wellhead prices -- rather than *away* from them, as is proposed by the other bills -- S. 2074 avoids the other proposals' substantial risks of renewed gas supply shortages and resultant costly economic and social dislocations. Price regulation at the wellhead is anathema to stable prices and supplies for the long run, and, without such stability, gas consumers will be unable to plan rationally the investments needed to fuel the Nation's economic recovery.

The Johnston bill's repeal of the Fuel Use Act, Title II of the NGPA ("incremental pricing"), and Title III of the Public Utility Regulatory Policies Act are all critical elements of gas reform legislation. These artificial demand restraints on selected sectors of the gas market have proven to be utter failures in holding down the rates of favored consumers; they have created an enormously complex regulatory morass; and they will become even less important as we move toward a freer market at the wellhead.

PGC does believe, however, that Sections 304 and 305 of S. 2074 are ill-conceived. These provisions would, in virtually all circumstances, guarantee that pipelines and distribution companies will be able to recover whatever gas costs they may incur, even if such costs are incurred as the result of abusive gas purchasing practices. These guaranteed cost passthrough provisions would be seriously damaging to consumers' ability to exert meaningful influence on the purchasing behavior of their gas suppliers. They would distort both supply and price since producers would be effectively insulated from knowing how much consumers actually value natural gas.

The rationality of a truly free market can never be established at the wellhead if consumers are rendered helpless to challenge the gas purchasing behavior of suppliers who abuse their natural monopoly status and their general ability to pass through the costs which they incur. PGC believes, therefore, that the grounds (set forth in NGPA Section 601(c)(2)) upon which pipeline gas purchase costs may be denied pass-through treatment should be expanded, not restricted in the manner proposed by S. 2074. Nevertheless, as discussed below, PGC does not believe that simply broadening NGPA Section 601(c)(2) alone would constitute a sufficient legislative response to the current chaos in the gas market.

As stated in its December 13, 1982 testimony before this Committee, PGC believes that complete deregulation of wellhead prices must be accompanied by a market-oriented resolution of the so-called "contract problem." While pleased that Senator Johnston included in S. 2074 a proposal for dealing with the contract problem, PGC believes that a more straight-forward approach might be more effective, such as an approach which (as discussed elsewhere in this letter) would encourage producers and purchasers voluntarily to renegotiate their existing contracts and which would facilitate such renegotiation. Although the contract conversion approach contained in S. 2074 is appealing because it would operate in a manner similar to the seller-buyer dynamics in a free market, that approach is extremely complex and therefore, as a practical matter, could create problems of its own. Moreover, its complexity aside, even if the bill's contract conversion approach were revised specifically to prevent the operation of above-market fixed price escalators (in addition to indefinite price escalators), there is little assurance that the provision could be framed to give gas purchasers effective protection against all kinds of problem contract clauses drafted to fall outside the bill's definition of "commodity escalator clause" (Section 404(b)), and such clauses could escalate prices above market clearing levels and lead to the kind of market disruptions the bill is intended to avoid.

Notwithstanding, however, these specific criticisms of certain provisions of the bill, PGC does believe that, if revised consistent with the foregoing, S. 2074 represents a generally sound compromise of the issues which have arisen under the NGPA. Enactment of such legislation would give rise to more stable and likely lower gas prices for all consumers; would allow gas supply and demand to come into balance (insuring adequate long-term gas supplies after the current short-term surplus ends); permit less volatile and more secure market revenues for pipelines and distribution companies; permit gas producers the cash flow they need to finance gas exploration and development activities; and eliminate the incentives which gas producers now have to produce high-cost gas resources before lower-cost resources.

II. Two of the pending bills fall into the second general category, providing for a temporary freeze on wellhead prices. Both S. 3054 and S. 3069 provide generally for a two-year price freeze and two-year delay of the NGPA's scheduled deregulation of certain gas categories.

A freeze on wellhead prices would, at best, simply halt the inexorable price increases being experienced under the NGPA; it would not allow gas consumers to see any reduction in their gas bills. Moreover, any price relief which is experienced may likely be short-lived. This is due to the fact that freezing price ceilings at mid- to late-1982 levels would be an invitation, if not an order, for renewed gas shortages. It would severely undermine exploration and development for new reserves and, at the same time, send a signal to users to increase consumption. With the elimination of incentives and the gradual erosion of price ceilings by inflation, these freeze provisions would send a message to producers that Congress cannot be trusted to fulfill its commitment to deregulation and that permanent regulation might occur. As shortages develop, there would be greater demand not only for imported oil, but also for imported gas at unfrozen prices. Thus, any potential cost savings resulting from the freezing of domestic gas prices would be reaped by foreign producers, not by gas consumers -- just as was the case in the pre-NGPA era.

In addition, the rididity of these price freeze proposals would deprive the gas market of all flexibility to meet changed circumstances until a new crisis forced Congress back into the picture -- creating the potential for a replay of 1978's sorry experience with gas legislation.

By returning to a fully price-controlled environment, the financial situation of all sectors of the gas industry would suffer as market volatility makes it substantially more difficult to plan exploration, purchasing, and marketing activities.

Today's gas market problems are due in large part to the fact that, in 1978, Congress did not go far enough, not because it went too far. The solution, therefore, to today's problems do not lie in regressing to the pre-NGPA price-controlled approach, but rather in fixing the flaws in the NGPA in order to permit the transition to a fully decontrolled market to be effected more smoothly and effectively.

III. The third general category of the legislative proposals includes those which reflect the belief that a Draconian solution to the "contract problem" is all that is needed to "fix" the NGPA. This category includes S. 2892 (introduced by Senator Jepsen), S. 3028 (introduced by Senator Metzenbaum),

S. 3054 (introduced by Senator Kassebaum), */ S. 3070 (introduced by Senators Danforth and Eagleton), S. 3076 (introduced by Senator Specter), and S. 3088 (introduced by Senator Chafee). These proposals range from outright blanket prohibitions against all take-or-pay clauses and indefinite price escalators to a broad expansion of the grounds upon which the FERC may block the passthrough of pipeline purchase costs and act to revise or annul contract terms. (Some of these bills also provide certain reporting requirements under which pipelines report to FERC their progress in achieving the lowest possible weighted average gas acquisition cost.)

Although PGC agrees that piplines' take-or-pay obligations are unreasonably high in many contracts negotiated under the NGPA, we also recognize that take-or-pay clauses provide producers (particularly independents) with some income stability and the cash flow needed to finance new exploration

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*/ S. 3054 combines its proposed "contract problem" solutions with a proposed price freeze. This combination of proposals makes it even less desirable than bills which propose simply one or the other. S. 3054 would devastate gas exploration and development and inevitably lead to supply curtailments to gas consumers. Faced with frozen prices, plus a loss of take-or-pay commitments (and the appearance that Congress will keep extending controls), domestic producers would slash their exploration and development budgets. Significant gas curtailments could begin quickly in some areas of the country and adversely affect meaningful economic recovery. Again, Canadian, Mexican, and Algerian producers would be in the best position to take advantage of such shortages by raising their prices while U.S. producers are prohibited from raising theirs and eliciting greater domestic supplies.

and development. A blanket prohibition against take-or-pay clauses would, therefore, cause an immediate reduction in exploration and development and then eventual shortages. Moreover, such a prohibition would be yet another boon for foreign gas producers who would be exempt under it (see, e.g., S. 3076).

An outright ban on all take-or-pay clauses would also result in rising gas prices as producers lose cash flow stability and markets begin to tighten up. In exchange for their added risks, producers would demand higher sales prices to justify their investment in exploration and development, and the tighter markets would enforce those demands for higher prices. (If a freeze proposal were also enacted, the higher prices would not be avoided; they would simply be collected by foreign gas sellers.) As a result, gas consumers would be dealt a double blow: forced to pay both the higher charges commanded by foreign or domestic producers plus a larger share of the pipelines' and distributors' fixed costs as their markets shrink.

Further, apart from the enormous administrative burden which would result from the exemption provisions of S. 3070 and S. 3076, pipelines which are totally freed from take-or-pay obligations would be placed in a strong position to favor their own gas production affiliates at the expense of potentially lower-priced gas from independent producers.

Finally, although PGC certainly supports measures to encourage pipelines to purchase first the cheapest gas available, the rigid "cheapest-first" rule required by S. 3076 (and suggested by S. 3070) would be extremely complicated and expensive to implement. It would require many pipelines to adopt complex new operating procedures and to install expensive metering equipment -- all of which would be paid for through higher rates to consumers. Moreover, it would inevitably lead to extensive litigation which, apart from the costs which it too would impose on ratepayers, would create the kind of uncertainty which seriously undercuts the ability of the gas market to develop and deliver secure long-term supplies.

With respect to proposals to expand the terms of NGPA §601(c)(2), PGC believes that the intent of such provisions in S. 2892, S. 3028, and S. 3054 is certainly laudable. Customer resistance to high gas prices is an essential element in bringing gas supply and demand into balance and keeping them there. Since interstate pipelines and local gas utilities are still subject to regulation (and will remain so even after full wellhead price decontrol), the ability of gas consumers to challenge excessive gas acquisition costs in regulatory forums is essential if pipeline purchasing practices are to be restrained, especially during the transition to full decontrol.

Thus, it is entirely appropriate that Congress include in gas reform legislation provisions to safeguard consumer's interests in this manner -- and reject the FERC's very narrow reading of Section 601(c)(2) which virtually wrote "abuse or similar grounds" out of the statute. Senator Jepsen's proposal in S. 2892 -- which would include a rebuttable presumption of "abuse" -- seems to be the most reasonable approach, allowing pipelines both (1) to know in advance which specific actions will render them potentially vulnerable under Section 601(c)(2), and (2) to rebut a charge of "abuse" by showing that an agreement to the disfavored contract terms is justified under the circumstances or is otherwise offset by other more favorable contract terms. */

It must be emphasized, however, that while PGC believes that the approach taken in S. 2892 is a good one, we also believe that adoption of such a measure alone will not be a sufficient legislative response to the problems of the gas market. In contrast, if the Jepsen bill were substituted for existing Sections 304 and 305 of S. 2074 (the Johnston bill), the result would be the kind of comprehensive legislation which would improve the long-term health and stability of the natural gas industry and its customers.

PGC Response to Senate Republican Question No. 2

PGC believes that the Federal Energy Regulatory Commission possesses substantial authority, under both the Natural

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*/ In contrast, the approaches suggested in S. 3028 and S. 3054 appear to be too open-ended and, therefore, too uncertain to afford either meaningful protection to consumers or meaningful guidelines for pipelines.

Gas Act and the Natural Gas Policy Act, to take action to address current and potential future problems in the gas market.

Under its general authority to regulate interstate transmission companies and its responsibility to protect consumers from the abusive purchasing practices of pipelines, FERC could and should take action, first, to protect consumers from the growing take-or-pay problems created by pipelines' contracts with producers and, second, to develop sound rate mechanisms to prevent pipelines from incurring extreme purchase gas costs, such as those prices in excess of $9.00/Mcf we have observed in the last two years.

I. Authority to Review Pipeline's Gas Purchasing Practices 1/

Regulation of interstate pipelines dates from the Natural Gas Act of 1938, which declared that "the business of transporting and selling natural gas for ultimate distribution to the public is affected with a public interest, and that federal regulation . . . thereof . . . is necessary in the public interest". NGA §1(a)). Regulation of producer prices dates, however, from the Supreme Court's 1954 decision in Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672.

1/ This discussion is a summary of the comprehensive treatment of FERC regulatory authority contained in Application for Rehearing of Statement of Policy of Process Gas Consumers Group, et al., March 9, 1982, Docket No. PL82-1-000. A copy of the full Application is enclosed as Attachment 1.

Prior to Phillips, the FPC maintained that it lacked authority to regulate the justness and reasonableness of producer prices, even while it consistently maintained that it had authority to regulate pipeline wholesale rates, including the authority to protect consumers from excessive or abusive pipeline gas purchasing practices. Phillips ruled that the Commission had the authority and the obligation to determine the justness and reasonableness of producer prices, and the Commission exercised this authority until the NGPA was enacted in 1978. Section 601(b) of the NGPA provided that the price charged by the producer is deemed to be just and reasonable if it does not exceed the applicable Title I price ceiling. In addition to this test of §601(b), under Section 601(c)(2)(B) the FERC may not deny any interstate pipeline recovery of any amount paid with respect to any purchase of natural gas unless the Commission determines "that the amount paid was excessive due to fraud, abuse or similar grounds" (hereinafter the "fraud or abuse" standard).

Thus, while the NGPA removes from the Commission the authority to regulate broadly the justness and reasonableness of producer prices, PGC does not believe that the NGPA intended for the Commission to abandon effective rate regulation of pipelines. To the contrary, through the fraud or abuse standard the Congress preserved for the Commission the authority to protect consumers from the abusive purchasing practices of pipelines. The NGPA otherwise would have recreated the regulatory gap with respect to pipeline wholesale rates that the Natural Gas Act was enacted to remedy.

On February 4, 1982, the FERC issued (Docket No. PL82-1-000) a non-binding "Policy Statement" interpreting the term "fraud, abuse, or similar grounds" in Section 601(c) of the NGPA, to include only acts or practices amounting to a "misrepresentation". PGC disagrees with this reading and argues that the fraud or abuse standard is not limited to instances of misrepresentation, but includes other types of conduct as well. The Commission's interpretation is so narrow that it would preclude even minimal steps to assure that interstate pipelines do not abuse their fundamental duty to provide adequate gas service to their customers at the lowest reasonable cost. In fact, as PGC pointed out in its application for rehearing of the Commission's Policy Statement, FERC's interpretation would render the NGPA's fraud or abuse standard a virtual nullity. This is so because any misrepresentation about either the true price paid or the proper NGPA price level would render passthrough unlawful independent of the Act's fraud or abuse standard. Unlawful payments and false claims about payments that were not actually made are banned from inclusion in pipeline rates anyway; thus, it would have been superfluous for Congress to have adopted Section 601(c)(2) if its scope was intended to be limited to cases of misrepresentation. Moreover, such direct violations of the NGPA would be separately punishable by Section 504 of the NGPA.

In this regard, the NGPA Conference Report states that pipelines may pass through costs of natural gas purchases if the price "does not exceed the ceiling price levels established under the legislation". Nevertheless, even if the price is lawful under Title I, "the conferees do not intend to guarantee passthrough of costs of natural gas purchases in cases of fraud or abuse as determined by the Commission". Consequently, the fraud or abuse standard must mean something more than simply misrepresenting the lawfulness of the producer prices allowed under Title I.

Many federal and state statutes confer benefits or privileges but leave to an administrator or regulatory authority the residual power to determine if the benefit or privilege has been abused. In fact, Congress has used the fraud or abuse standard to circumscribe a variety of technically legal but generally inappropriate types of behavior in a number of statutes in recent years. As these terms are generally understood, acts of misrepresentation may be fraudulent or abusive. But acts which are neither fraudulent nor misrepresentative may also result in an abuse. Consistent with the dictionary definition of "abuse," such acts may include "excessive, improper, or extravagant use" of the privileges conferred by the statute.

In the case of interstate pipelines and other regulated entities, the privilege conferred by statute is a franchise or a certificate to do business as a regulated monopoly. Interstate pipelines operate under certificates of public convenience and necessity issued under the Natural Gas Act, subject to regulatory review of their rates by the Federal Energy Regulatory Commission. This authority permits the Commission to police not only cases of outright fraud or concealment, but also cases of abuse where the pipeline has made excessive, improper, or extravagant use of the privileges afforded, or where it has disregarded the duty imposed by its certificates of public convenience and necessity. Such review of pipelines' costs in rate cases is entirely consistent with the authority to deny their passthrough in cases of fraud, abuse, or similar grounds under the NGPA. In fact, the prudency of electric utilities' purchases of coal to fire their generators is frequently reviewed without anyone charging that FERC or state commissions are trying to engage in "back door" regulation of the coal mining industry. The point is simply that, in the context of regulated monopolies, there is no competition to assure that pipelines minimize their costs and rates as would occur in a free market. Regulatory oversight and the power to exclude excessive gas costs are, therefore, needed to perform that function.

PGC believes that, with respect to gas purchase costs, the NGPA preserved the FERC's authority to protect consumers both (1) from abuses of the wide discretion normally afforded to pipeline management in its efforts to provide full service at the lowest reasonable cost, and (2) from distorted purchasing practices which seriously undercut the NGPA's effort to achieve a smooth transition to substantial deregulation. In a sense, the fraud or abuse standard is a safety valve to be used if pipelines fail to protect their customers or if partially deregulated markets run amok.

Recent FERC Developments

Recent developments at the FERC indicate some movement at the Commission toward some of PGC's views of FERC's overall authority.

First, in its order in Tennesee Gas Pipeline Company's PGA case (TA82-2-9) the FERC declared that prudence and incentive rate structure issues will be the subject of hearings in Tennessee's pending general rate case, Docket No. RP82-125, and it directed intervenors to file briefs to discuss the alleged nature of Tennessee's imprudence and potential remedies (as well as the area of expected discovery and the allocation of burden of proof). Similar orders were subsequently issued with respect to a number of other pipelines.

Second, on December 30, 1982, Presiding Administrative Law Judge Michel Levant issued his initial decision in Columbia Gas Transmission Corporation's 1981 PGA cases, Docket Nos. TA81-1-21 and TA81-2-21. In this decision, the ALJ reached three broad and very significant conclusions:

(1) The ALJ rejected the narrow interpretation of the NGPA's fraud or abuse standard set forth in the FERC's Statement

of Policy. Instead, following the reasoning first set forth at length in PGC, et al.'s Application for Rehearing of the Policy Statement (Attachment 1 hereto), the ALJ found that "the term 'abuse' may comprehend inappropriate activities, in addition to misrepresentation, that surpass imprudence".

(2) The ALJ found that pipelines have a continuing duty under the Natural Gas Act to provide service at the lowest reasonable rates possible and that an abuse of this duty can be treated as a violation of the NGPA's fraud or abuse standard. In this regard, the ALJ accepted the basic thrust of PGC's concept of the term "abuse".

(3) The ALJ found that the FERC retains authority to order pipelines to desist from unjust and unreasonable gas purchasing practices under Section 5 of the Natural Gas Act, even when those practices do not rise to the level of an "abuse."

II. Action to be Taken by FERC 2/

A. Take-or-Pay Clauses in Gas Purchases Contracts

The FERC should use its authority to exclude imprudent take-or-pay costs from pipelines' rates. In fact, PGC has suggested that the FERC should affirmatively encourage the development of take-or-pay clauses in gas purchase contracts

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2/ This discussion is a summary of recommendations made in PGC's August 26, 1982 comments in FERC Docket No. RM82-26-000. These comments are enclosed as Attachment 2.

which provide either (a) that the purchaser's take-or-pay obligations decline from a maximum of 85%-90% as the prices paid for natural gas increase above a Commission-approved level (e.g., a Section 102 price or the average wellhead price expected to prevail in a free market), or (b) that the purchaser's take-or-pay commitment not exceed a fixed percentage approved by the Commission.

As previously noted, the Commission has the legal authority to limit the rate treatment of imprudent take-or-pay costs. However, implementing that authority to deal with serious take-or-pay problems in existing contracts will not be an easy matter due to the hearings and proof needed to support findings of imprudence. The Commission recently recognized the lawfulness of excluding imprudent take-or-pay costs when it issued a statement of policy which established a rebuttable presumption that take-or-pay levels higher than 75% in future gas contracts will be deemed imprudent. This action, however, fails to deal with the problem of existing gas contracts.

B. Application of the Fraud, Abuse, or Similar Grounds Standard

The Commission should adopt certain rebuttable presumptions to govern interstate pipelines' PGA rate cases as they closely examine pipeline purchasing practices. Specifically, at a minimum, a pipeline should be affirmatively required to rebut the presumption that its gas costs are not "excessive due to fraud, abuse or similar grounds" in at least the following instances:

(a) in any case in which it has failed to exercise market-out clauses or similar renegotiation clauses in existing contracts, notwithstanding the adverse effects high prices are having on the pipeline's ability to resell gas;

(b) in any case in which it has failed to include market-out or similar renegotiation clauses in contracts for deregulated gas, especially contracts containing definite or indefinite pricing clauses which will predictably take the price of gas above the level which would be expected to prevail in a free market environment; and

(c) in cases in which prices for new gas exceed the range of prices which would be expected to prevail in a truly free market.

C. Rate Mechanisms to Provide Economic Incentives for Sound Gas Purchasing Practices

For the interstate gas system to function efficiently and reliably, the Commission must develop sound rate mechanisms to assure that pipelines have adequate incentives to keep deregulated gas costs within reasonable bounds while providing full service to their customers. Apart from the critical need to move away from the currently-prevalent "United" rate design and toward one which assigns all fixed costs to the demand component of rates and all variable costs to the commodity component of rates, PGC has two suggestions for incentive rate mechanisms (either of which may reasonably be expected to be vigorously opposed by pipelines):

1. An Incentive Sales Level

As one possible incentive to keep gas supplies marketable, the Commission could calculate unit rates on the basis of its best estimates of the sales level which would be achieved if the pipeline provided full service without incurring gas purchase costs above a level specified by the Commission. Under such an "incentive sales level" approach, the Commission would estimate the volume of sales which would occur, for example, if the pipeline met all of its customers' requirements without its average gas costs exceeding the price level expected to prevail in a functioning free market. With rates so calculated, any decline in sales -- whether attributable to curtailments or to unreasonable gas purchase costs -- would result in lost profits for the pipeline. Such a result would be similar to the type of profit reduction which competitive companies and their stockholders would expect if the companies incurred unreasonable operating costs.

While an incentive sales level would provide an incentive for keeping gas costs down to a reasonable level, there would necessarily be some difficulty in estimating the level of sales which would likely occur if the pipeline pursued reasonable gas purchasing policies. However, given the fact that routine estimates of sales levels, which are contained in pipelines' test period adjustments, already account for potential conservation and fuel switching in most cases, the Commission and the parties before it have some experience in this area. In any event, a reasonable estimate should be possible, even if perfection is not.

An incentive sales level scheme might be a particularly effective method for giving pipelines an incentive to deal with the "contract problem" before 1985. This could be accomplished, for example, by freezing the sales volumes used in calculating rates applicable during 1985 at the level of actual sales during 1984.

2. Sliding Rate of Return

The Commission should also consider adopting a sliding rate of return on equity which would reward pipelines for maintaining full service at low gas costs (relative to a predetermined measure) while penalizing curtailments and/or unduly high gas costs. The essential contours of an incentive rate of return scheme can be defined generically, even though implementation would require some case-specific data.

Initially, the Commission would have to define the range over which the rate of return could vary depending upon the pipeline's gas purchasing practices. One obvious possibility would be to employ a "range of reasonableness" within which the Commission would ordinarily establish a pipeline's rate of return. Once the range is established, the scale for rewarding or penalizing departures from the mean would need to be established. At one end, such a scale should reward full service at low gas costs, while, at the other end, it should penalize curtailments and unduly high gas costs. In the case of curtailments, demand charge adjustments would also be appropriate.

Conclusion

Even though PGC believes that FERC possesses substantial authority to deal with problems in the gas market, we strongly argue that legislation is still necessary for two reasons.

First, as reflected in the foregoing discussion, there is disagreement even at the Commission itself as to the extent of its authority. Therefore, even if the FERC were to adopt some or all of PGC's suggestions for action, there would without doubt be challenges to such action, leading to prolonged uncertainty during the lengthy process of judicial review of the scope of FERC's statutory authority.

Second, most of these recommendations have prospective application only, whereas many of the legislative solutions operate retroactively. For example, the PGC proposal set forth in our December testimony would provide for renegotiation of existing contracts to resolve the "contract problem."

January 21, 1983

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PGC Response to Democratic Question No. 1

PGC believes that the best solution to the contract problem is to facilitate voluntary renegotiation of gas contracts by the parties who must live with those gas purchase contracts in the future. Renegotiation by the parties will produce better results than will Congressional efforts to structure gas purchase and sales arrangements by fiat from Washington, D.C. In view of the substantial surplus of deliverable supplies that now exists, consumers should be the principal beneficiaries of renegotiation at this time, while both producers and consumers will benefit from wellhead price deregulation over the longer term.

To accomplish the desired result Congress should enact legislation (a) which provides for deregulation of all supplies over a short, but reasonable phase-out period and (b) which inserts a renegotiation clause in all contracts in existence on day of enactment which cover sales by a producer to a buyer for resale to third parties.

As envisioned by PGC, the renegotiation clause would enable either party to request reopening of the contract for renegotiation. If a resolution satisfactory to both parties is not achieved, within a specified period (e.g., 90 days from the request for reopening) then either could opt out of the contract and seek other buyers or sellers of gas.

To provide supply stability to pipelines, it would be reasonable to give pipelines a right of first refusal in cases in which a producer opts out in favor of another buyer. However, to protect independent producers from potential bad faith bargaining tactics, pipelines would not be given a right of first refusal in cases in which the pipeline was the one to opt out of a contract. Similarly, to protect independent producers from abuses of pipelines' monopsony power, pipelines would have to be obligated to provide transportation services at "just and reasonable" rates approved by the FERC in the event a producer sold gas to a third party.

This type of solution would be similar to the "market out" clause mechanism which some pipelines and producers have included in their contracts for deregulated gas in recent years. Those clauses recognize that, while parties desire long term contracts, they must be free to adapt price and non-price terms to meet changing market conditions over time.

By inserting these clauses in all contracts existing at the time of enactment, all parties to wellhead gas sales contracts would be able to insist on renegotiating their contracts. Consequently, any party with an unfavorable contract relative to prevailing market conditions would be able to bring its contract in line with the current market. Self-interest should assure that this is done and should prevent any party from overreaching during the difficult transition to full decontrol. Thus, it would be unlikely that Congress would have to get back into the picture. However, to assure a continuing vehicle for contract adjustment, the legislation could provide that the renegotiation clauses would remain in all contracts (including new ones) for at least one year after the completion of phased decontrol. At that point, the market should be well balanced, and buyers and sellers will likely voluntarily include market out clauses as a routine matter.

Monitoring should be done by FERC. FERC would be authorized to collect data on contract renegotiations and would require public filing of existing and new contracts. There should be a clarification of FERC's power to protect consumers from prices which result from abuses of a pipeline's management discretion or its duties to its customers. The purpose of this action would not be to permit "backdoor" producer regulation, but solely to protect consumers from an aberrant pipeline's efforts to use its monopoly position to pass through excessive costs resulting from serious errors of management judgement. Customers of regulated pipelines should not have to absorb higher gas costs than the pipelines could charge if they resold gas in a competitive market.

PGC Response to Democratic Question No. 2

PGC believes that it is important to combine deregulation with measures designed to deal with the contract problem described elsewhere in Mr. Elam's statement. The problem is that gas purchase contracts signed in the regulated environment of the Natural Gas Act and Natural Gas Policy Act were premised upon assumptions which are unrealistic under today's circumstances and might be even less appropriate in a totally deregulated environment.

To be sure, if there were deregulation without a contract fix, the market would eventually work itself out as the inability to sell available gas would force pipelines and producers to renegotiate their contracts. However, before renegotiation could occur on a widespread basis, substantial market losses would have to occur and the FERC would have to convince pipelines that they could not expect to recover all of their costs until they restored their markets to health. Even then, pipelines might be forced to act unilaterally in the case of some contracts with producers, and extensive, potentially harmful litigation would result.

Thus, merely deregulating gas after nearly 30 years of regulation without taking steps to resolve the contract problem, would have markets facing serious hurdles along the road to equilibrium. At least in a deregulated environment, there would be a hope of achieving lasting equilibrium, while, under the NGPA, serious market disorders are almost guaranteed to recur from time to time as price and other restrictions interfere with buyers' and sellers' abilities to meet changing market conditions.

January 21, 1983

Attachment #1

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

In the Matter of:	)	
	)	
Fraud Standard in	)	Docket No. PL82-1-000
Section 601(c)(2)	)	
of the NGPA	)	

APPLICATION FOR REHEARING OF STATEMENT OF POLICY OF THE PROCESS GAS CONSUMERS GROUP, THE AMERICAN IRON AND STEEL INSTITUTE, ASSOCIATED BUSINESSES ADVOCATING TARIFF EQUITY, THE BRICK PEOPLE, ET AL., AND THE GEORGIA INDUSTRIAL GROUP

In accordance with Section 1.34 of the Commission's Rules of Practice and Procedure, the Process Gas Consumers Group, The American Iron and Steel Institute, Associated Businesses Advocating Tariff Equity, The Brick People, et al., and the Georgia Industrial Group (hereinafter referred to collectively as "The Industrial Groups") respectfully apply for rehearing of the Statement of Policy ("Statement") issued on February 4, 1982. In support hereof, The Industrial Groups respectfully state as follows:

I.

Communications concerning this Application should be addressed as follows:

Edward J. Grenier, Jr.
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II. DESCRIPTION OF APPLICANTS

The Process Gas Consumers Group ("PGC") is an association of industrial consumers of natural gas organized to promote the development and adoption of coordinated, rational and consistent federal and state policies with respect to industrial gas use. PGC members own and operate hundreds of plants in virtually every state in the Nation. The members of PGC participating in this matter are: Aluminum Company of America, American Can Company, American Standard Inc., Armco Inc., Bethlehem Steel Corporation, Burlington Industries, Inc., Cone Mills Corporation, Corning Glass Works, Dan River Inc., General Motors Corporation, 3M Company, Owens-Corning Fiberglas Corporation, Owens-Illinois, Inc., and United States Steel Corporation.

The American Iron and Steel Institute ("AISI") is the principal trade association of the steel industry. Its 63 domestic member companies account for approximately 92 percent of the raw steel production capability in the United States. (Armco Inc., Bethlehem Steel Corporation, and United States Steel Corporation, members of AISI, are also members of PGC).

Associated Businesses Advocating Tariff Equity ("ABATE") is an association of industrial energy consumers located in the State of Michigan. The members of ABATE, all of whom are substantial consumers of natural gas, are Abitibi Price Corporation, Bundy Corporation, Clark Equipment Company, Detroit-Strip Division of Cyclops Corporation, Dow Chemical, U.S.A., Edward C. Levy Company, Escanaba Paper Company, Ford Motor Company, General Motors Corporation, Great Lakes Steel Division of National Steel Corporation, Haworth Manufacturing Inc., Hayes-Albion corporation, Huron Valley Steel Corporation, James River Corporation, Kastle Steel Corporation, McLouth Steel Corporation, Michigan Sugar Company, Monitor Sugar Company, Motor Wheel Corporation, Quanex Corporation, Stanley Door Systems, and Wolverine Aluminum Corporation.

The Brick People, Region VI of the Brick Institute of America, and Dickey Clay Manufacturing Co., (the "Brick People _et al._") is a group of brick and sewer pipe manufacturers located in the Midwest. The Brick People include Sioux City Brick & Tile Co., Endicott Clay Products Co., Yankee Hill Brick Mfg. Co., Can-Tex Industries, Sheffield Brick & Tile Co., United Brick & Tile Co., and Ochs Brick & Tile Co. All of the members of the group receive natural gas from the Northern Natural Gas Company system.

The Georgia Industrial Group ("GIG") is an organization of industrial users of natural gas located in the State of Georgia. Participating members of GIG are American Industrial Clay Company of Sandersville, Anglo-American Clays

Corporation, Burgess Pigment Company, Engelhard Corporation, Minerals & Chemicals Division, General Motors Corporation, Georgia Kaolin Company, Midland Glass Company, Inc., Nord Kaolin Company, Pabst Brewing Company, and Thiele Kaolin Company.

Members of PGC, AISI, ABATE, The Brick People, *et al.*, and GIG purchase natural gas directly or indirectly from interstate and intrastate pipelines, with most of their facilities on the interstate system.

III. STATEMENT OF ALLEGED ERRORS AND SUMMARY

The Statement adopts a non-binding interpretation of the term "fraud, abuse, or similar grounds" (hereinafter "fraud or abuse standard") in Section 601(c) of the Natural Gas Policy Act of 1978 ("NGPA"), which would include only acts or practices amounting to a "misrepresentation." The Industrial Groups respectfully submit that the fraud or abuse standard is not limited to instances of misrepresentation, but includes other types of conduct as well. The Commission's interpretation is so narrow that it would preclude even minimal steps to assure that interstate pipelines do not abuse their fundamental duty to provide adequate gas service to their customers at the lowest reasonable cost.

Singling out acts of misrepresentation as the only type of conduct cognizable under Section 601(c) is arbitrary, capricious and patently unlawful. Although misrepresentation may be an important element of an act of "fraud," there is no basis for concluding that misrepresentation is a necessary element of an act of "abuse" or "similar grounds." The Commission's tentative interpretation of "abuse" is at odds with common sense, the dictionary, other federal statutes, and regulatory precedent. The Commission's purposeful disregard of these relevant authorities is a fatal defect in the Statement.

Nor can the arbitrary definition of abuse as a lesser form of fraud be justified by the structure and legislative history of the NGPA. It is disquieting that the Commission should devote so much discussion to the terrible problems now facing natural gas pipelines only to conclude that the NGPA left it powerless to deal with them. These market ordering problems arise in large part, as the Commission acknowledges, from events not foreseen by Congress in enacting the NGPA, particularly the large increase in world oil prices after 1978. Nevertheless, FERC concludes that Congress intended that Section 601(c) not be used to address these problems. This conclusion is based almost exclusively on the conclusion that Section 601(c) was not intended to result in "back-door" regulation of producer prices. Apart from the unreliable legislative history on which this conclusion is based, it does not even come to grips with the real issues posed by Section 601(c).

The Industrial Groups respectfully submit that the fundamental issue is not whether the Commission shall regulate *producers*, but whether it shall regulate *pipelines*. It is not whether the Commission shall *reimpose* the price controls on *producers* that were removed by the NGPA, but whether it shall *free pipelines* from the regulatory responsibility for their gas purchasing practices imposed by the NGPA and the Natural Gas Act. The NGPA simply took away from the Commission the authority to determine the justness and reasonableness of producer prices, which had been thrust upon it by the Supreme Court in *Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672 (1954). It did not eliminate the Commission's pre-*Phillips* authority to regulate pipeline wholesale rates and to protect consumers from abusive or excessive pipeline purchasing practices.

The Industrial Groups also submit that the abuse standard may be used to address market disorder problems. The Commission acknowledges that the responsibility for defining "fraud or abuse" has been delegated largely to it alone. At a minimum, we believe that the NGPA preserved the FERC's authority to protect consumers both from abuses of the wide discretion normally afforded to pipeline management in its efforts to provide full service at the lowest reasonable cost, and from distorted, short sighted purchasing practices which seriously undercut the NGPA's effort to achieve a smooth transition to substantial deregulation. In a sense, the fraud or abuse standard is a safety valve to be used if pipelines fail to protect their customers or if partially deregulated markets run amok.

IV. ARGUMENT

A. The Commission's Definition of "Fraud, Abuse or Similar Grounds" is at Odds With the Plain Language of the Statute.

Limiting the separate terms "fraud, abuse, or similar grounds" to acts of misrepresentation is, on its face, untenable. It would virtually read the terms "abuse" and "similar grounds" out of the Act. It is at odds with the plain meaning of the terms and with their usage in similar regulatory contexts. And it ignores contemporaneous Congressional usage of the "fraud or abuse" standard in other federal programs.

1. The Commission's Definition Would Read the Fraud or Abuse Standard Out of the NGPA.

The Commission's proposed definition appears to read the fraud or abuse standard out of the statute by limiting it to cases where prices are excessive due to misrepresentation. It is difficult to see where this standard would be invoked except in cases in which a price is unlawfully high due to misrepresentation. But a higher than lawful maximum price cannot be recovered in any case, and the fraud or abuse standard comes into play only after it is determined that the producer's price is lawful under Title I.

That is, the fraud or abuse standard is only at issue if, under Section 601(c)(2)(A), the price charged by the producer is deemed to be just and reasonable for purposes of Sections 4 and 5 of the Natural Gas Act. The price will be deemed to be just and reasonable under Section 601(b) only if it does not exceed the applicable maximum lawful price established under Title I or the gas is subject to ceiling price deregulation. If the producer price has met the tests of Section 601(b) and 601(c)(2)(A), it is, by definition, a lawful price under Title I and just and reasonable under the Natural Gas Act.

Since the fraud or abuse standard may come into play only if the price is deemed to be just and reasonable, what role would a misrepresentation test play? Certainly no misrepresentation as to the price paid by the pipeline to the producer would be included, since an unlawful price may not be passed through to consumers in any event. 1/ Knowing and willful violations of any provision of the NGPA are separately punishable by the Commission under its enforcement authority in Section 504 of the Act.

The NGPA Conference Report states that pipelines may pass through costs of natural gas purchases if the price "does not exceed the ceiling price levels established under the legislation." Nevertheless, even if the price is lawful

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1/ It should be noted that a price in excess of any applicable contract is unlawful under Title I even if the contract price is below an otherwise applicable ceiling price. Neither the producer nor the pipeline may recover a price for gas in excess of the lower of: (1) the ceiling price, if one is applicable; or (2) the contract price. See §101(b)(9). Any price paid in excess of either the ceiling price or the contract price would be a violation of the Act by either the producer, the pipeline, or both, and the price would not be just and reasonable under Section 601(b).

under Title I, "the conferees do not intend to guarantee pass through of costs of natural gas purchases in cases of fraud or abuse as determined by the Commission." 2/ Consequently, the fraud or abuse standard must mean something more than simply misrepresenting the lawfulness of the producer prices under Title I.

2. The Terms "Fraud," "Abuse" and "Similar Grounds" Must Have Independent Meanings.

The "fraud, abuse, or similar grounds" standard is phrased in the disjunctive. Pipeline cost passthrough will be denied if prices are found to "excessive" due to either fraud, or abuse, or similar grounds. Yet the Commission has ignored the plain and separate meanings of the terms "abuse" and "similar grounds" by limiting them to acts of misrepresentation. Misrepresentation may be an important element in an act of "fraud," but not in the other acts described in Section 601(c).

The Statement defines fraud and abuse principally by reference to the law of misrepresentation as set forth in Professor Prosser's treatise on torts, 3/ an odd choice to say the least. The exclusive reliance on this source and the disregard of many other more obvious ones is a major defect in the Statement. See Concurring Opinion of Commissioner Hughes at at 2. 4/

Black's Law Dictionary, for example, defines abuse thus: "to make excessive or improper use of a thing, or to employ it in a manner contrary to the natural or legal rules for its use; to make extravagant or excessive use, as to abuse one's authority." 5/ This definition is consistent with use of the term in the regulatory context. The Commission notes, for example, that the word "abuse" in a state statute permitting the regulation of railroads has been judicially defined

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2/ H.R. Rep. No. 95-1752, 95th Cong., 2d Sess. (1978) at 124.

3/ Statement at 34-35, citing W. Prosser, Handbook of the Law of Torts (4th ed. 1971).

4/ Compare, for example, the wide range of possible sources for the word "fraud" identified by the Concurring Opinion of Commissioners Holden and Hughes in Columbia Gas Transmission Co., Docket No. TA81-1-21-001 (April 30, 1981; Concurring Opinion issued May 12, 1981), at 8-9.

5/ 4th ed., 1968, pp. 24-25.

to mean "any improper use of a right or privilege; as abuse of a franchise." 6/ Other state utility cases have focused on the "disregard of a duty imposed by law." 7/

Both the dictionary and state regulatory cases indicate that "abuse" includes much more than "misrepresentation." Yet after acknowledging these state cases, the Commission inexplicably and erroneously returns to its fraud analogy and limits abuse to a "misrepresentation made in disregard of a duty." (Statement at 45). This arbitrary definition cannot be supported. (See Concurring Opinion of Commissioner Hughes at 1).

Many federal and state statutes confer benefits or privileges but leave to an administrator or regulatory authority the residual power to determine if the benefit or privilege has been abused. Acts of misrepresentation may be fraudulent or abusive. But acts which are neither fraudulent nor misrepresentative may result in an abuse. Such acts may include "excessive improper, or extravagant use" of the privileges conferred by the statute.

In the case of interstate pipelines and other regulated entities, the privilege conferred by statute is a franchise or a certificate to do business. Interstate pipelines operate under certificates of public convenience and necessity issued under the Natural Gas Act, subject to review of their rates by the Federal Energy Regulatory Commission. This authority permits the Commission to police not only cases of outright fraud or concealment, but also cases of abuse where the pipeline has made "excessive, improper, or extravagant" use of the privileges afforded, or has "disregarded the duty" imposed, by its certificates of public convenience and necessity. Such review of pipeline's costs in rate cases is entirely consistent with the authority to deny passthrough in cases of fraud, abuse, or other similar grounds under the NGPA.

Commissioners Holden and Hughes were therefore correct in their Concurring Opinion to the Commission's April 30 Order in Columbia Gas Transmission Co., Docket No. TA-81-

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6/ Statement at 42, citing Ry Comm'n of Texas v. Houston T.C.R. Co., 38 S. Co. 750, 754 (1897).

7/ Statement at 43. See also Concurring Opinion of Commissioners Holden and Hughes, supra, note 4 at 10-11, and cases there cited.

1-21-001, 8/ when they described "abuse" as an "abuse of discretion." They correctly observed that the Natural Gas Act imposes certain limits on the discretion that reposes in the managements of natural gas pipelines. NGPA Section 601 remains as a check on that discretion. As the Concurring Opinion put it:

> "The Congress, through the Natural Gas Policy Act, has determined to reside much wider discretion as to gas purchasing decisions in the managements of natural gas companies. Yet the Commission is still left with some authority to determine what actions by managements of natural gas companies can be called into question as arguable indicators that such discretion has been abused." (Concurring Opinion at 11).

At a minimum, the Industrial Groups believe that the NGPA preserved the FERC's authority to protect consumers both from abuses of the wide discretion normally afforded to pipeline management in its efforts to provide full service at the lowest reasonable cost, and from distorted purchasing practices which seriously undercut the NGPA's effort to achieve a smooth transition to substantial deregulation. In a sense, the fraud or abuse standard is a safety valve to be used if pipelines fail to protect their customers or if partially deregulated markets run amok. The Statement of Policy thus errs in arbitrarily limiting cases of abuse to acts of misrepresentation.

3. The Definition Ignores Similar Federal Statutes.

The terms "fraud" and "abuse" have been regularly inserted in a wide variety of legislation to permit the administering agency not only to police and enforce the commands of the statute but also to address more widespread problems which arise out of its implementation. Our review disclosed at least thirteen federal statutes employing the phrases "fraud" and "abuse," and numerous others which employ the word "abuse" without employing the word "fraud." 9/

8/ See note 4, supra.

9/ For the use of the word abuse on its own see, e.g., Fair Debt Collection Practices Act, P.L. 95-109 (Sep. 20, 1977), codified at 15 U.S.C. §1692; Condominium and Cooperative Abuse Relief Act of 1980, P.L. 96-399 (Oct. 8, 1980), codified at 15 U.S.C. §3601, 3601(a)(3); Interstate Commerce Act Amendments, P.L. 95-473 (Oct. 17, 1978), P.L. 96-448 (Oct. 14, 1980), codified at 49 U.S.C. §10505(a)(2).

Congress was not therefore acting in the dark when it included similar langauge in the NGPA. Three specific examples enacted by the same Congress that enacted the NGPA are discussed below.

In 1977, Congress enacted the "Medicare-Medicaid Antifraud and Abuse" amendments. 10/ Congress determined that the Medicaid and Medicare programs had failed to operate in conformity with their original intent. The Conference Report noted that program fraud and abuse had arisen in a variety of contexts. Therefore, Congress emphasized that the responsible regulatory agency has wide latitude to curb "abuses" which do not conform to the regulatory scheme. The Conference Report distinguished the terms fraud and abuse, making clear that abuse includes acts other than misrepresentation:

> "Fraud involves an intentional deception or misrepresentation, with the intent of receiving some unauthorized benefit for the individual engaged in fraud. In the health area, examples of fraud may include: billing for services not rendered, misrepresentation of services rendered, kickbacks, deliberate duplicate billing, false or misleading entries on cost reports, and so forth. Program abuse is less clearly defined and includes activity wherein providers, practitioners, and suppliers of services operate in a manner inconsistent with accepted, sound medical or business practices resulting in excessive and unreasonable financial cost to either medicare or medicaid. Included in the area of abuse are the provision of unnecessary health services and the provision of necessary care in unnecessarily costly settings." 11/

10/ P.L. 95-142 (Oct. 25, 1977), codified at 42 U.S.C. §1320c-15(b).

11/ H.R. Rep. No. 95-393 (II), 95th Cong., 2d Sess. (1977), reprinted in 1977 U.S. Code Cong. & Admin. News 3039, 3050 (emphasis added). In 1976, Congress had established the Office of Inspector General in the Department of Health, Education, and Welfare to prevent and detect "fraud and abuse" in the Department's programs. 42 U.S.C. §§3521-24. The 1977 amendments retained the substantive "fraud or abuse" standard but provided additional enforcement powers to implement the statutory standard.

Similarly, in October 1978, contemporaneous with the enactment of the NGPA, Congress enacted legislation to curb fraud and abuse in the Comprehensive Employment and Training Program ("CETA"). 12/ Congress recognized that "abuse" is a broad term, flexible enough to include a wide range of activities which may threaten the "integrity" of CETA program. 13/ A long nonexclusive list of activities was identified which could constitute abuse, and the regulatory agency was directed to establish standards "to assure against program abuses." These abuses include but are not limited to:

> "nepotism; conflicts-of-interest; the charging of fees in connection with participation in the program; excessive or unreasonable legal fees; the improper commingling of funds under the chapter with funds received from other sources; the failure to keep and maintain sufficient, auditable, otherwise adequate records; kickbacks; political patronage; violations of applicable child labor laws; the use of funds for activities which are not directly related to the proper operation of the program." 14/

Finally, in the Department of Energy Organization Act, the Inspector General was established and given a broad mandate to seek out "fraud or abuse in programs and operations of the Department." (DOE Act §208(b)). The scope of the mandate extends the concept of "abuse" far beyond "fraud" or misrepresentation and equates it more generally with "serious problems, abuses and deficiencies relating to the administration of programs and operations administered or financed by the Department." (DOE Act §208(b)(4)).

Thus, it is clear that the 95th Congress used the term abuse, in conjunction with the term "fraud," to include a broad range of activities inconsistent with the goals of particular legislation, not simply misrepresentations.

12/ P.L. 95-524 (Oct. 27, 1978), codified at 29 U.S.C. §816, 825.

13/ S. Rep. No. 95-891, 95th Cong., 2d Sess. (1978), reprinted at 1978 U.S. Code Cong. & Admin. News 4501.

14/ 29 U.S.C. §825(g).

B. The Commission Definition of "Fraud, Abuse, or Similar Grounds" is At Odds with the Structure and History of the NGPA and the Natural Gas Act.

1. The NGPA Deregulated Producer Prices, Not Pipelines.

The Statement argues that Section 601(c) was intended to prevent "back-door" producer price regulation, a that any pipeline regulation which affects producer prices directly or indirectly, would violate the Congressional intent. (Statement at 8-13, 46).

Applicants submit that the fundamental issue is ot whether the Commission shall regulate producers, but wheth it shall regulate pipelines. It is not whether the Commission shall reimpose the price controls on producers that w re removed by the NGPA, but whether it shall free pipelines f om the regulatory responsibility for their gas purchasing pra tices imposed by the NGPA and the Natural Gas Act. The FE 's extreme interpretation of Section 601(c) would turn a stat te intended partially to deregulate producers into one which would deregulate pipelines as well. This it cannot do.

Under both the NGPA and the Natural Gas Act, the activities of interstate pipelines are cloaked with the pu lic interest, convenience and necessity. The public inter st would not be served by granting pipelines carte blanche in the exercise of any important aspect of their utility-type function, including gas purchasing.

Regulation of interstate pipelines dates from th Natural Gas Act of 1938 which declared that "the business transporting and selling natural gas for ultimate distribution to the public is affected with a public interest, and that federal regulation . . . thereof . . . is necessary i the public interest." (NGA §1(a)). Regulation of produce prices dates, however, from the Supreme Court's 1954 decis on in Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672.

Prior to Phillips, the FPC maintained that it la ted authority to regulate the justness and reasonableness of p oducer prices, even while it consistently maintained that i had authority to regulate pipeline wholesale rates, includ ng the authority to protect consumers from excessive or abusi pipeline gas purchasing practices. Phillips ruled that th Commission had the authority and the obligation to determi the justness and reasonableness of producer prices, and th Commission exercised this authority until the NGPA was ena ted in 1978. While the NGPA removes from the Commission the authority to regulate broadly the justness and reasonableness of producer prices, nothing in the NGPA indicated an intent that the Commission should abandon regulation of pipelines. To the contrary, through the fraud or abuse standard the Congress preserved for the Commission the authority to protect consumers from the abusive purchasing practices of pipelines. The NGPA thus restores the Commission to the role it traditionally exercised prior to the Phillips case. To read the NGPA otherwise, would be to recreate the regulatory gap with respect to pipeline wholesale rates that the Natural Gas Act was enacted to remedy.

The important Commission role in regulating pipeline rates prior to Phillips was described in Phillips in the dissenting opinion of Justice Clark:

> "That Congress aimed at abuses resulting in the 'gap' at the end of the transmission process by integrated and unintegrated pipelines and not at abuses prior to transmission is clear from the final report of the Federal Trade Commission to the Senate on malpractices in the natural gas industry. S. Doc. No. 92, 70th Cong., 1st Sess. (1935). This report was the stimulus for federal intervention in the industry. The Federal Trade Commission outlined the abuses in the industry which the 'gap' made the states powerless to prevent; the abuses were by monopolistically situated pipelines which gouged the consumer by charging local distribution companies unreasonable rates. The Federal Trade Commission did not find abusive pricing by independent producers and gatherers; if anything, the independents at the producing end of the pipelines were likewise the victims of monopolistic practices by the pipelines."
> 347 U.S. at 695-696.

See also, Phillips Petroleum Co. v. Wisconsin, 347 U.S. at 688 (Douglas, J., dissenting), "Congress was concerned with interstate pipelines not with independent producers." 15/

15/ And see FPC v. Hope Natural Gas Co., 320 U.S. 591, 609-610 (1944):

(Continued on next page)

The abuses identified by Justice Clark remain as real a danger today as when the Natural Gas Act was enacted.

In analyzing Section 601(c)(2), the Commission must not confuse regulation of the "justness and reasonableness" of producer prices with protecting consumers from abuses of management discretion and similar lapses by pipelines. When the *Phillips* case ruled that the Natural Gas Act's "just and reasonable" standard was to be applied directly to producers, it obviously imposed a much more stringent form of price regulation than existed when the Commission had merely reviewed pipelines' purchasing practices for prudence and abuses of discretion. The marked difference between the two levels of regulation is clearly illustrated both by the *Phillips* case, which rejected the argument that Commission review of pipelines' purchasing practices for abuses was sufficient to protect consumers, and by subsequent cases. 16/ Thus, in reading the language of Section 601(c), it is clear that Congress has only reversed the *Phillips* requirement that all producer

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> "The purpose of the Natural Gas Act was to provide, 'through the exercise of the national power over interstate commerce, an agency for regulating the wholesale distribution to public service companies of natural gas moving interstate, which this Court had declared to be interstate commerce not subject to certain types of state regulation.'"

16/ For example, in *Atlantic Refining Co. v. Public Service Comm. of N.Y.*, 360 U.S. 378 (1959), the Supreme Court recognized three possible levels of agency review concerning the initial producer rates in a certificate case. It clearly distinguished between (1) the Presiding Examiner's standard of "imprudence or abuse of discretion by management," (2) the ultimate Sections 4 and 5 test of "justness and reasonableness," and (3) the proper certificate test of "public convenience and necessity." The third test fell between the other two, with the "just and reasonable" standard the most stringent. Similarly, in *FPC v. Texaco*, 417 U.S. 387 (1974), the Supreme Court disapproved a proposal for indirect regulation of small producer prices because the Commission order purported to reject rates charged by small producers only if unreasonably high, rather than limiting those rates by the stricter "just and reasonable" standard. The Court ruled that, under the *Phillips* case, anything less stringent than the "just and reasonable" standard would be unlawful.

rates must be reviewed by the Commission under the "just and reasonable" standard. It did not preclude review of pipeline's abuses of discretion with respect to gas purchasing practices, as was permitted in the pre-Phillips period. Indeed, the final clause in Section 601(c) indicates that Congress intended review of pipeline practices to continue under a pre-Phillips-type standard which recognizes wide--but not unlimited-- management discretion.

In other contexts, the Commission has emphasized its authority to regulate pipeline rates and to disallow the flow through of rates which amount to an abuse of the pipeline's managerial discretion. As the Commission stated in Opinion No. 497, 36 F.P.C. 101, 70-71 (1968), citing the Supreme Court:

> "'The contention is made that the amount to be expended for these purposes is purely a question of managerial judgment. But this overlooks the consideration that the charge is for a public service, and regulation cannot be frustrated by a requirement that the rate be made to compensate extravagant or unnecessary costs for these or any purposes. Archer v. United States, 298 U.S. 426, 430-431 (1936)'".

The Commission added:

> "The Commission has no authority either to conduct or supervise the day-to-day operations involved in the production and transportation of natural gas in interstate commerce. Those functions are left to management for decision and the managers exercise a broad area of discretion in the conduct of their business affairs. In the exercise of the authority conferred upon us by the Natural Gas Act, our function is to review those business judgments to assure they do not impair and are consistent with the concomitant obligation of management to make available the natural gas supplies needed by the consuming public at the lowest reasonable rates consistent with the public interest.

> ... *Basically, unless an abuse of discretion is shown*, expenses incurred in the rendition of the service are primarily a matter of managerial judgment. *This does not mean, however, that extravagant and unnecessary costs can be imposed on the ratepayers, no matter how convinced management may have been that those costs were necessary in its own interest*." (*Id*.)

This principle remains applicable even though the NGPA provides for the deregulation of certain producer prices. As the Commission itself stated in *Phillips* in finding that it lacked authority to regulate independent producers:

> "Our conclusion that we are without authority to regulate the prices at which the producer and gatherer sells his gas to the pipeline does not leave the consuming public wholly without protection by us so far as this element in the cost of natural gas to the consumer is concerned .... *[I]n the exercise of its power to regulate the wholesale rates charged by interstate pipeline companies, this Commission has ample authority to inquire into the reasonableness of all items of operating expense -- including the cost of purchased gas -- and to disallow, for purposes of rate-making, items of cost which are collusive or otherwise improperly excessive.*" 10 F.P.C. 246, 280 (emphasis added).

In sum, the traditional descriptions of the Commission's authority to review pipeline costs -- "abuse of discretion," "extravagant and unnecessary costs," and "collusive or otherwise improperly excessive" -- parallels closely the phrase "excessive due to fraud, abuse, or similar grounds."

With this background, it is no exageration to say that the Commission's Statement of Policy could return pipelines to the unregulated period prior to 1938, insofar as gas acquisition costs are concerned. No challenge to the volumes, prices, or terms of purchases of deregulated gas would be permitted unless the excessively high prices resulted from "misrepresentation." Other types of abusive practices, such as excessive and unwarranted purchases of high priced gas, including purchases which might threaten the continued viability of service to certain customer classes or the economic viability of the pipeline itself would be beyond question. Even agreements to pay $20 or $50 per Mcf for gas would be unreviewable, as would be schemes to pay excessive prices to affiliates under cover of one or two extreme agreements with unaffiliated producers pursuant to the affiliate entities test of Section 601(b)(1)(E). Such results would be unsupportable.

Permitting such abuses of discretion by pipelines is not consistent with any reasonble interpretation of the Commission's regulatory role. Nor is it consistent with the fundamental structure of pipeline rate regulation which was developed long before the Commission was compelled to regulate producer rates. Even if Congress intended no indirect or "back-door" producer regulation with respect to deregulated gas, as the Commission contends, it is clear that it never intended to permit pipelines to escape entirely regulatory scrutiny for their gas purchasing decisions. Congress may have deregulated some wellhead prices; it certainly did not deregulate pipelines.

2. The Commission Has Authority to Address Market Ordering Problems Under the Abuse Standard.

The Commission argues that the NGPA created a "dysfunctional" market situation, and that it cannot exercise its powers under Section 601(c) to bring order to the market by regulating deregulated gas prices. The Commission mistakes the issues posed by the present market situation and understates its authority to correct that situation.

The fact that the natural gas market is presently disorderly and dysfunctional does not resolve the question of whether, collectively or individually, pipelines have responded reasonably to the new market environment. In fact, today's extreme gas purchasing practices will pose grave dangers for the pipeline's customers over the next several years, as the Commission recognizes. In these circumstances, it is all the more important for the Commission to review what the pipelines are doing.

The Commission's protestations that it has no authority under Section 601(c) to address market ordering problems are completely undercut by the lengthy explanation it provides of the seriousness of those problems. It is disquieting, at the very least, to hear an agency describe the mounting calamaties befalling the industry it is charged to regulate, only for it to conclude that it should not do anything to mitigate those problems. The Industrial Groups use the word "should" advisedly, because the Commission acknowledges that "the task of defining what constitutes 'fraud, abuse, or similar grounds' is left entirely to it." (Statement at 12 (emphasis added)). 17/

Despite this important admission, the Commission has grasped at every straw in the structure and legislative history of the NGPA to argue that Congress intended the very market ordering problems that now are occurring, and to justify inaction on its part in solving them. This untenable reasoning collapses totally when the Commission states that the principal aggravating cause of market disorder is an event that Congress did not foresee and that in fact undermines the very assumptions on which the NGPA was premised -- namely a sharp increase in world oil prices after 1978. The Commission states:

> "The NGPA was intended to achieve a smooth transition to decontrol by retaining controls on some gas after 1985 and by applying an annual escalator to the statutory price ceilings before that date. However, given market events since passage of the NGPA, continued price controls on some categories of natural gas will do little if anything to smooth the transition. The price escalator provisions applicable to those categories will be largely ineffective because the rates of escalation were based on the world oil market in 1977 and 1978. Within months after enactment of the NGPA, however, world oil prices more than doubled. Since 1979, oil prices have remained generally stable or even declined somewhat. However, even without further increases, existing oil prices imply a price for either completely or partially deregulated natural gas that is far above the NGPA's statutory price ceilings. Because of the price spike that will be created by the NGPA, the transition to substantially increased partial decontrol in 1985 is likely to be far from smooth."

17/ Of course, the Commission's decisions, like those of pipeline managements, are also reviewable for "abuse of discretion."

(Statement at 23-24 (emphasis added) see also p. 13, 17).

Not only is it "excessive to conclude that Congress actually intended market disordering" (Statement at 48), it is completely erroneous to suggest, as the Commission seems to do, that Congress had any idea whatsoever of the events which took place subsequent to 1978 and which have now lead to market consequences quite different from those intended by Congress. Therefore, the issue is not whether the Commission should "undo what Congress has done" (Statement at 49), but whether it should take steps within its lawful authority to seek to mitigate market ordering problems that Congress never intended. 18/

The resulting situation is therefore "dysfunctional" to use the Commission's term, and the pipelines' response to this situation has been limited by the "relentless competition" among them for natural gas supplies (Statement at 21). Even if pipeline managements decide eventually that they must desist from further bidding (id. at 21), the seeds of continuing disorder have already been sown by the nature of the contracts already signed, which commit the pipelines to open-ended price escalations with prices constantly ratcheting upward without any realistic hope of downward adjustment. In this situation the Commission must use its authority under Section 601(c) to address programmatic abuses which are at the root of the current and future market disorder. (See pp. 8-10, supra).

18/ The NGPA's failure with respect to Section 107 gas is particularly obvious, as the Commission's Statement attests. Under Title II, the incremental pricing threshold for Section 107 gas is 130% of No. 2 fuel oil. (§203(a)(7)). If regulated gas prices were pegged to oil price equivalents, this threshold would make sense, because it would prevent Section 107 gas from capturing an undue premium over Section 102 gas through rolling in the price with the old gas cushion. But skyrocketing oil prices have led to a situation where the equivalent price of 130% of No. 2 fuel oil is about 3 times the price of Section 102 gas. As a result, the price relationship between 107 gas and Section 102 gas is widely out of line, and the incremental pricing provisions of Title II have played no effective role in moderating Section 107 prices.

In enacting the NGPA, Congress was instituting a new regulatory framework in which producer prices for certain categories of natural gas would remain subject to price controls; prices for other categories would be regulated for a limited period of time; and producer prices for yet other categories of natural gas were immediately deregulated. The drafters of the energy legislation did not have the benefit of reviewing an ongoing program and thus could not predict the types of "abuses" of the energy program which would cause prices of purchased gas to be excessive. Therefore, the NGPA left the FERC with the authority to protect consumers when gas purchase activities rose to the levels of an "abuse" of the regulatory program. But the Commission must exercise this discretion in defining "abuse" in a manner which is consistent with the legislative program to achieve a smooth transition to deregulation.

The Commission could utilize the abuse standard in several ways, including those spelled out in detail in the Petition for Rulemaking filed by Applicants on March 1, 1982. These steps include defining as an abuse certain escalator clauses in contracts which will be deregulated in 1985. Although indefinite price escalator clauses may be reasonable in times of relatively stable gas markets or regulated gas prices, they can be unreasonble and harmful in periods of great instability such as the gas industry faces in the next several years. By addressing such open-ended escalators, the Commission is addressing a clear and present danger to the stability of the natural gas industry, which is becoming greater every year, and which the NGPA was not designed to deal with, except through the fraud or abuse standard. Such a proposal would not be aimed at any particular price for gas, or any particular contract, but at the failure of pipelines industry-wide to protect their interests when deregulation occurs in 1985.

A second proposal would address the transition period to full deregulation and would deem it to be a presumptive abuse if a price for deregulated gas exceeded a Commission defined market clearing level. It should be stressed that applicants have not proposed to find abusive per se any such gas price. There could be many grounds on which any single gas purchase could be sustained, particularly the ground of need for the gas. The primary effect of such a proposal would be to shift the burden of justifying this activity to the pipeline, which presumably thought its purchase was justified when it entered into the purchase. If nothing else it will assure that all pipelines carefully consider the implications of their purchasing decisions before signing high cost gas contracts.

The problems faced by the natural gas industry during the next few years are extraordinary ones which should eventually fade as wellhead deregulation becomes more widespread. In more stable times, the "fraud, abuse or similar ground" standard might be rarely invoked, as in the relatively stable pre-Phillips period. Yet the Commission has adopted an interpretation which would be unduly narrow even in such more stable times and is wholly inappropriate now to address transitional problems which are extraordinarily destabilizing. The need for the Commission to rely on Section 601(c) will never be greater than at the present. This is the wrong time for the Commission arbitrarily to surrender an important tool in its regulatory arsenal.

V. CONCLUSION

WHEREFORE, for the foregoing reasons, The Process Gas Consumers Group, The American Iron and Steel Institute, Associated Businesses Advocating Tariff Equity, The Brick People, et al., and The Georgia Industrial Group respectfully seek rehearing of the Statement of Policy issued February 4, 1982.

Respectfully submitted,

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and The Georgia Industrial Group

March 5, 1982

AFFIDAVIT

District of Columbia) ss:

Robert W. Clark III, being first duly sworn, says that he is Counsel for the Process Gas Consumers Group, et al.; that he has read the foregoing documents and is familiar with the contents thereof; that he has executed the same on behalf of said party with full power and authority to do so; and that the statements set forth herein are true and correct to the best of his information, knowledge, and belief.

Robert W. Clark

Robert W. Clark III

Subscribed and sworn to before me this 5th day of

March, 1982.

Notary Public

My Commission Expires November [illegible], 1985

Attachment #2

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

In the Matter of	)	
	)	
Impact of the NGPA ON	)	
Current and Projected	)	Docket No. RM82-26-000
Natural Gas Markets	)	

COMMENTS OF THE PROCESS GAS CONSUMERS GROUP, THE AMERICAN IRON AND STEEL INSTITUTE, THE ASSOCIATION OF BUSINESSES ADVOCATING TARIFF EQUITY, THE BRICK PEOPLE, ET AL., AND THE GEORGIA INDUSTRIAL GROUP, ON NOTICE OF INQUIRY ISSUED APRIL 28, 1982

Edward J. Grenier, Jr.
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August 26, 1982

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

In the Matter of	)	
	)	
Impact of the NGPA on	)	
Current and Projected	)	Docket No. RM82-26-000
Natural Gas Markets	)	

COMMENTS OF THE PROCESS GAS CONSUMERS GROUP, THE AMERICAN IRON AND STEEL INSTITUTE, THE ASSOCIATION OF BUSINESSES ADVOCATING TARIFF EQUITY, THE BRICK PEOPLE, *ET AL.*, AND THE GEORGIA INDUSTRIAL GROUP, ON NOTICE OF INQUIRY ISSUED APRIL 28, 1982

In response to the Notice of Inquiry ("NOI"), issued by the Commission on April 28, 1982, the Process Gas Consumers Group, The American Iron and Steel Institute, the Association of Businesses Advocating Tariff Equity, The Brick People, *et al.*, and the Georgia Industrial Group (hereinafter referred to collectively as "The Industrial Groups") respectfully submit their written comments.

Communications concerning this document should be addressed as follows:

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I. STATEMENT OF PARTIES AND INTEREST

The Process Gas Consumers Group ("PGC") is an association of industrial consumers of natural gas organized to promote the development and adoption of coordinated, rational and consistent federal and state policies with respect to industrial gas use. PGC members own and operate hundreds of plants in virtually every state in the Nation. The members of PGC particiapting in this matter are: Aluminum Company of America, American Can Company, American Standard Inc., Armco Inc., Bethlehem Steel Corporation, Burlington Industries, Inc., Cone Mills Corporation, Corning Glass Works, Dan River Inc., General Motors Corporation, 3M Company, Owens-Corning Fiberglas Corporation, Owens-Illinois, Inc., and United States Steel Corporation.

The American Iron and Steel Institute ("AISI") is the principal trade association of the steel industry. Its 63 domestic member companies account for approximately 89 percent of the raw steel production capability in the United States. (Armco Inc., Bethlehem Steel Corporation, and United States Steel Corporation, members of AISI, are also members of PGC).

The Association of Businesses Advocating Tariff Equity ("ABATE") is an association of industrial energy consumers located in the State of Michigan. The members of ABATE, all of whom are substantial consumers of natural gas, are: Abitibi-Price Corporation, Bundy Corporation, Clark Equipment Company, Detroit-Strip Division of Cyclops Corporation, Edward C. Levy Company, Escanaba Paper Company, Ford Motor Company, General

Motors Corporation, Great Lakes Steel Division of National Steel Corporation, Haworth Manufacturing Inc., Hayes-Albion Corporation, Huron Valley Steel Corporation, James River Corporation, Kastle Steel Corporation, McLouth Steel Corporation, Michigan Sugar Company, Monitor Sugar Company, Motor Wheel Corporation, Quanex Corporation, Stanley Door Systems, and Wolverine Aluminum Corporation.

The Brick People, Region VI of the Brick Institute of America, and Dickey Clay Manufacturing Co., (the "Brick People et al.,") is a group of brick and sewer pipe manufacturers located in the Midwest. The Brick People include Sioux City Brick & Tile Co., Endicott Clay Products Co., Yankee Hill Brick Mfg. Co., Can-Tex Industries, Sheffield Brick & Tile Co., United Brick & Tile Co., and Ochs Brick & Tile Co. All of the members of the group receive natural gas from the Northern Natural Gas Company system.

The Georgia Industrial Group ("GIG") is an organization of industrial users of natural gas located in the State of Georgia. Participating members of GIG are American Industrial Clay Company of Sandersville, Anglo-American Clays Corporation, Burgess Pigment Company, General Motors Corporation, Georgia Kaolin Company, Midland Glass Company, Inc., Nord Kaolin Company, Pabst Brewing Company, and Thiele Kaolin Company.

Members of PGC, AISI, ABATE, The Brick People, et al., and GIG purchase natural gas directly or indirectly from interstate and intrastate pipelines, with most of their facilities on the interstate system.

II. SUMMARY -- A COMPREHENSIVE, BALANCED REMEDY FOR MARKET DISORDER IS REQUIRED.

On March 1, 1982, the Industrial Groups filed a Petition for Rulemaking with the FERC asking that it develop a comprehensive program to alleviate market disorders occurring under the Natural Gas Policy Act of 1978 ("NGPA"). The Petition stated that, in the absence of legislative revision of the NGPA, the FERC is duty bound to take administrative action under existing authority to attempt to stabilize gas prices and supplies during the transition to a less regulated market in 1985. The Petition presented proposals to deal with several interrelated problems, including pricing, gas supply, and contract issues. As further support for some of their proposals, the Industrial Groups filed a lengthy Application for Rehearing of the "Statement of Policy" issued by the Commission on the meaning of the "fraud, abuse or similar grounds" test under Section 601(c) of the NGPA. */

The Notice of Inquiry seeks public comment on most of the proposals made by the Industrial Groups, as well as proposals made by other parties. In these comments, the Industrial Groups will elaborate upon their earlier proposals and comment

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*/ Fraud Standard in Section 601(c)(2) of the NGPA, Docket No. PL82-1-000, Statement of Policy, issued February 4, 1982.

upon others mentioned in the NOI. In addition, we will respond to the Commission's request for additional data regarding the nature and extent of market ordering problems under the NGPA. Before addressing these subjects in detail, however, a few basic points should be stressed.

The Industrial Groups reaffirm their previously expressed view that market disorder problems are serious and may grow worse as 1985 approaches. The fact that three pipelines have reportedly invoked market-out clauses under Section 107 contracts and that oil prices have continued to be relatively weak do not indicate that the market will "correct itself" as some have suggested. To date, other pipelines have failed to take the needed steps; some lack adequate market-out clauses in their Section 107 contracts; and few have market-out clauses to deal with soaring prices in contracts for gas to be deregulated in 1985. Thus, the actions by Transco, Mich Wis and United simply illustrate that the problems predicted for 1985 are approaching sooner than expected. As predicted, the NGPA is producing pipeline-by-pipeline and region-to-region disparities in burner tip gas prices with prices on some pipelines rising to a level equal to or above the price of competing fuels, threatening permanent industrial load loss. And, the market impact of contract provisions calling for automatic escalations in natural gas prices is yet to be fully realized. Further complicating the picture, some knowledgable observors are predicting that shortages could occur in a few years.

The fact is that no one in the gas industry can predict with certainty what will happen either between now and 1985 or after deregulation occurs in 1985. In the absence of sound legislation, administrative actions are needed more than ever to restore some semblance of stability to gas markets and to smooth the transition to decontrol.

The Industrial Groups' petition outlined a number of steps which the FERC can take within its existing legal authority. These proposals include both incentives and disincentives for pipelines and producers, and they are intended to result in a comprehensive approach to a variety of problems under the NGPA.

Although we recognize that alternative approaches might also be suitable, the Industrial Groups wish to reemphasize in the strongest possible terms that whatever remedies are adopted must involve a comprehensive, balanced approach which addresses a number of problems. The Commission must take into account the contract problem as well as wellhead pricing disparities and must consider the needs of consumers as well as producers, and distributors as well as pipelines. In our view, for example, the Commission should not deal solely with wellhead pricing disparities or only with contracting problems; rather it must deal with both types of problems, and the solutions adopted with respect to one should be viewed in terms of their impact on the other.

For this reason, the Industrial Groups' proposal concerning wellhead prices is inextricably tied to contract changes and is not aimed at raising gas prices just to achieve higher prices. As outlined in Part IV of these comments, the Industrial Groups support some moderate administrative steps to revise the NGPA's distorted wellhead price structure, provided that such steps are conditioned to assure demonstrable benefits for consumers in the form of a fair resolution to the contract problem. Without this important nexus, however, wellhead price increases for old gas cannot be justified.

The "contract issue" includes a variety of separate but related problems arising from pipeline relations with producers. The Industrial Groups have, correspondingly, proposed a number of approaches for dealing with these problems. No one of these approaches provides a full answer. For example, our proposal in Part IV to condition increases in old gas prices on renegotiation of new gas contracts would not reach all new gas contracts nor address all the potential problems with such contracts. For this reason, we have proposed other measures under the Natural Gas Act ("NGA") and the NGPA to deal with prices and other contract terms, such as market-out clauses and take-or-pay problems. These measures, which are outlined in Part V, Sections A and B of these comments, would provide guidance for interstate pipelines and would clearly place the burden on them to justify charging customers for extreme take-or-pay or gas purchase costs. Placing that burden on the pipelines will help both to protect consumers from unreasonable pipeline purchasing practices and to pressure pipelines to resolve their contract problems before the worst impacts occur.

Ultimately, for the interstate gas system to operate effectively in a deregulated environment, it is necessary that rate structures be in place which will give interstate pipelines meaningful economic incentives to keep their resale rates at the lowest reasonable level while providing full service to their customers. Unless pipelines know that their money is at risk when they purchase extremely high cost supplies, the problems we see now will recur in one form or another indefinitely. Thus, the Commission must consider the steps it can take to establish long-term mechanisms for holding pipelines to the same economic standards that apply to other businesses with products to sell. Two possible mechanisms to achieve this goal are outlined in Part V, Section C of these comments. These should be explored, along with other possible rate structures, in both generic and individual rate proceedings to assure that proper incentives are in place well before 1985.

In Part VI of these comments, the Industrial Groups argue for rejection of the artifical and discriminatory rate mechanisms proposed by California and Laclede Gas Company. As explained in detail in that section, those proposed departures from rolled-in pricing are based on fundamentally flawed premises and would produce undesired and discriminatory results.

Finally, it is important to keep the need for, and possible effects of, administrative action in proper perspective. Administrative action is desperately needed in the absence of legislation. Although the FERC cannot change the basic ground rules established by the NGPA, it can take a number of reasonable, balanced steps to mitigate (not wholly eliminate) current and future market disorders. Because these disorders have their origins in over 25 years of ill-fated wellhead price regulation, however, they will not be cured overnight. Consequently, in order to do as much good as possible before large volumes of gas are deregulated in 1985, it will be necessary for the Commission to make concrete proposals as part of a comprehensive rulemaking, as soon as possible. The longer the Commission waits, the harder it will be for it to exert meaningful influence on events before or after January 1, 1985.

III. MARKET DISORDER - FACTUAL BACKGROUND

The Petition for Rulemaking filed by the Industrial Groups emphasized the serious disorders occuring in the natural gas markets under the NGPA. The NOI, like the Commission's Statement of Policy, issued in Docket No. PL82-1-000 on February 4, 1982, ably outlines the types of problems at issue and seeks further information as to the severity of these problems and the need for remedial action. In these comments, the Industrial Groups will respond to the Commission's request for more detailed data. The Industrial Groups strongly believe that the NGPA has caused serious market disorder problems and that, in the absence of legislative revision of the NGPA, strong Commission action is urgently necessary to address these problems.

In this portion of the comments we shall discuss, first, wellhead pricing problems; second, the so-called "contract problem"; and finally, the question of whether recent events demonstrate that the market may correct itself.

A. Wellhead Prices

Contrary to the claims of some, implementation of the wellhead pricing provisions of the NGPA (Title I) is not proceeding as intended. Although intended by its authors to provide a mechanism for a smooth transition to a deregulated market, Title I has not worked because of inherent flaws in its structure and many pipelines' short-sighted gas purchasing practices.

Because of its part-regulated, part-deregulated structure, Title I is severely distorting the exploration and development, distribution, and price of natural gas in the United States. The statute is causing rapidly rising wholesale and retail prices without inducing corresponding increases in long-term gas supplies; it is producing surpluses in some locations while, although masked by the current recession, the potential for shortages are arising in others; it may be contributing to the demand for high cost energy imports; and it is producing significant price disparities across the country. Further, the problems are likely to get worse, not better, over the next several years.

1. Regional and Pipeline Distortions.

The provisions of Title I appear to be seriously distorting the allocation of natural gas supplies among pipelines and regions. Although these effects are currently being masked by the recession's sharp reduction in gas demand, many intrastate and interstate pipelines have been severely disadvantaged in the competition to acquire new supplies under the Title I scheme.

As the NOI notes, the problem stems from Title I's "vintage" price and partial deregulation structure, which, as of August 1982 set ceiling prices for regulated categories ranging from 28¢ per thousand cubic feet ("Mcf") for some old interstate gas (Section 104) to $3.17 per million Btu

("MMBtu") for "new natural gas" (Section 102) to $3.40 per MMBtu for stripper well gas (Section 108). Of these categories, some gas sources will be deregulated in 1985, some in 1987, and some will never be deregulated by the NGPA.

On the other hand, Section 107 of the NGPA has already deregulated the price of natural gas from four types of wells -- (1) gas from new wells drilled to a depth of more than 15,000 feet, (2) geopressurized methane, (3) gas produced from coal seams, and (4) gas produced from Devonian Shale -- and these prices currently go well over $9.00 per Mcf.

The crude oil equivalent of NGPA prices for the major price-controlled categories of gas would range from $1.62 per barrel (equivalent to 28¢/Mcf Section 104 gas) to $18.39 per barrel (equivalent to $3.17/MMBtu Section 102 gas). As a result, producers of the narrow categories of deregulated gas, as well as foreign countries, can command extraordinary prices before "average" market clearing prices are reached at the retail level. Thus, while the average wellhead price for gas was estimated by the Department of Energy to be $2.39 per Mcf in March, 1982 (the equivalent of $13.86 per barrel of crude), Section 107 gas is frequently selling for substantially above $9.00 per Mcf -- *i.e.*, almost four times DOE's estimate of the average wellhead price for gas and the equivalent of $52 per barrel oil. Similarly, Trunkline Gas Company has told FERC that it expects to pay $7.38 per MMBtu for delivered Algerian LNG -- even if the f.o.b. price is not escalated. At least three other major pipelines are also seeking to import Algerian LNG.

The uneven distribution of gas subject to permanent price controls under the NGPA will likely cause major supply and price problems both before and after substantial volumes of gas are deregulated in 1985. As pipelines with disproportionately large shares of the cheap gas cushion outbid others for new supplies, some pipelines could have shortages while others have surpluses, and the price of gas in some areas will exceed average market clearing levels for reasons entirely unrelated to pipeline economics. These distortions will, in turn, cause significant economic problems for gas consumers, including industrial users. Moreover, large rate differences will likely exist even between neighboring communities in the same state which happen to have different pipeline suppliers. */

a. Interstate v. Intrastate Pipelines

Evidence that the old gas cushion gives interstate pipelines a significant advantage over intrastate pipelines can be seen in several ways:

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*/ The old gas cushion continues to be relevant to buyers' relative gas purchasing positions notwithstanding the fact that market clearing has been reached in some areas. The fact remains that market clearing has not been reached in many other areas. Moreover, even in areas where market clearing has been reached, gas prices could fall below market clearing again, if gas demand were increased, for example, by rising oil prices. Then, the gap between old gas prices and market clearing would increase, thereby restoring the gas purchasing advantage inherent in the old gas cushion.

(1) In 1979, gas reserve additions were 30% less than gas production on a national basis, while in the interstate market, gas reserve additions exceeded production by 21%, according to FERC data. In 1980, that disparity widened as gas reserve additions were 14% less than production on a national basis, but interstate reserve additions were 48% more than interstate production.

(2) While several interstate pipelines appear to have temporary oversupplies, intrastate pipelines in Louisiana have just the opposite problem, having had to turn to interstate pipelines to buy so-called "dump gas" in order to get by in the short-term.

(3) A DOE compilation of data filed with the FERC also demonstrates the interstate advantage. */ For example, according to Section 102 filings through April 30, 1981 (i.e., new natural gas discovered after February 19, 1977), interstate buyers in Louisiana were obtaining 93% of the estimated Section 102 production; in Texas, 64% of that production; and in Oklahoma, 62%.

(4) Many intrastate pipelines will see their old gas cushions disappear in 1985 since, under NGPA

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*/ See "The Natural Gas Market Under the NGPA" (DOE/EIA/AR-0289, June 1981).

Sections 105 and 106, intrastate gas whose contract price exceeds $1.00/MMBtu by the end of 1984 will be decontrolled on 1/1/85. */

b. Differences Among Interstate Pipelines

The problem of uneven supply distribution, however, is not merely an interstate versus intrastate problem. No two interstate pipelines have the same mix of old gas sources, and neighboring pipelines serving the same states can have very different supply and price positions. Thus, while most observers agree that the interstate market as a whole will have a substantially larger cushion of price regulated gas in 1985 than will the intrastate market, the distribution of the cushion is very uneven among interstate pipelines. This fact is demonstrated by the attached table (Appendix A), which shows estimates of 24 interstate pipelines' deliveries of permanently price-controlled gas as a percentage of their total gas deliveries. Plainly, some interstate pipelines will be far worse off than others, and some interstate pipelines will likely be worse off than some intrastate pipelines.

Appendix A represents the Industrial Groups' attempt to estimate the distribution of the old gas cushion among interstate pipelines. The estimates are based upon a review of annual gas supply projections (Form 15) filed with the FERC

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*/ Intrastate pipelines face a further gas supply hurdle inasmuch as their access to federal offshore gas reserves is limited.

by most major interstate pipelines. (No comparable source exists for intrastate pipelines).

Inasmuch as most of the cushion of permanently price-controlled gas will be based upon gas reserves dedicated to interstate commerce prior to April 20, 1977, data in the 1977 and 1980 Form 15's make it possible to approximate each pipeline's total 1985 deliveries from its own old gas cushion, as well as from its pipeline suppliers' old gas cushions. */ By assuming that each pipeline will acquire as much gas in 1985 as it actually purchased or produced in 1980, one can then estimate the size of each pipeline's cushion relative to its total supply needs. That is the basis for the estimates in Appendix A. **/

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*/ Thus, for example, in its Form 15 for report year 1977, which was filed on April 1, 1978, each major pipeline stated its actual gas production, purchases, and total reserves for the year ending December 31, 1977; it projected total annual deliveries for twenty years from dedicated proven gas reserves and other sources under contract as of December 31, 1977; and it provided detailed five-year data for each source. Data on actual deliveries during 1977 and the 20-year "deliverability" projections are broken down between deliveries of "owned and contracted" proven reserves (i.e., expected deliveries from dedicated proven reserves owned by the pipeline or under a gas purchase contract with a producer) and "pipeline purchases" (i.e., expected deliveries from other pipelines, LNG operations, etc.). Further information concerning the basis for the deliverability projections can be found in the various schedules contained in the Form 15. Similar data are found in the 1980 Form 15s.

**/ The 1977 Form 15 is important because it indicates the volume of gas deliveries expected from dedicated gas reserves and pipeline suppliers under contract as of December 31, 1977. Since most gas dedicated to interstate commerce after April 20, 1977 will be deregulated in either 1985 or 1987, and since most

(Continued on next page)

While the figures in Appendix A represent only approximations, and while the DOE and FERC could -- indeed, should -- use their greater resources to produce more precise pipeline-by-pipeline projections, the Industrial Groups' estimates provide at least a general guide concerning the relative positions of most pipelines. */

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gas dedicated before April 20, 1977 will never be deregulated under the NGPA, the Industrial Groups have used the Form 15 for the year ending December 31, 1977 for estimating the annual deliveries expected in 1985 from all owned and contracted gas reserves that will remain price-controlled permanently. Using the 1977 and 1980 Form 15's of each pipeline and its pipeline suppliers, an estimate was developed of the volume of permanently price-controlled gas that will be delivered to each pipeline by its pipeline suppliers in 1985. Efforts were made to exclude imports, which are not subject to NGPA price controls and which have been priced to take advantage of the cushion rather than to contribute to it. Then, by totaling the estimated deliveries of "cushion" volumes from "owned and contracted" and pipeline sources, and by assuming that each pipeline's total sales 1985 will equal its 1980 levels, an estimate was made of each pipeline's total deliveries from all permanently price-controlled sources as a percentage of its total deliveries from all sources. This is the basic approach underlying the Industrial Groups' estimates.

*/ Obviously, for example, estimates based on Form 15 data depend directly on the accuracy of individual pipelines' projections of 1985 deliveries, which may be high or low; and estimated percentages will be affected to the extent total 1985 deliveries are higher or lower than in 1980. Further, the Industrial Groups' cushion estimates may be high to the extent they include deliveries from reserves dedicated between April 20 and December 31, 1977, although they may be low to the extent they exclude deliveries from post-1977 wells on OCS tracts leased before April 20, 1977. Also, some projected imports may have been included within estimates of owned and contracted supplies and thus may not have been excluded from the estimated price-controlled cushion. Other factors may also be relevant to the size of individual pipelines' cushions in 1985, although they may tend to be offsetting and should not cause major changes for many pipelines. Apart from the volumes of the deliveries of price-controlled gas, one would also need to know the prices being paid for new and old gas in order to know whether a pipeline's customers are well protected. That would require a far more detailed study than can be undertaken here.

As illustrated by Appendix A's estimates of 24 pipelines' relative deliveries from permanently price-controlled sources, the differences among pipelines are potentially dangerously large. For example:

- Of the 24 pipelines, the average of the estimated cushions of the four best situated pipelines is four times as large as the average for the four pipelines that are worst off.
- The estimated cushion of the eighth ranked pipeline in 1985 is fully twice as large as that of the 19th ranked pipeline and nearly four times as large as those of the two worst situated pipelines.

The information in Appendix A also shows that, even within the interstate gas market, significant regional and local differences will exist as a result of the uneven distribution of the cushion:

- Many eastern and southern states and some midwestern states could be hurt economically as a result of the difficulties faced by Mississippi River Transmission, United, Kentucky-West Virginia, Trunkline, Southern Natural, and Transcontinental.

- Eastern and midwestern states served by Panhandle Eastern, Texas Gas, National Fuel, Columbia, Michigan Wisconsin, and Algonquin may also be disadvantaged.
- Several states, such as Pennsylvania, New Jersey, Kentucky, New York, and Missouri, may find that prices and supply availability will vary widely among communities as a result of differences among pipelines serving those states.

While these estimates are only approximate, they are sufficient to show some of the dangers of allowing the NGPA to run its course without amendment or without some ameliorative administrative action.

The magnitude of the differences among interstate pipelines can also be illustrated by the fact that, according to an *Energy User News* survey of pipeline sales and revenue in May 1982, the average wholesale rates charged by major interstate pipelines varied by as much as $3.13 per Mcf -- from $5.40 charged by Great Lakes Transmission Company to $2.27 charged by Kansas-Nebraska Natural Gas. Even *neighboring* pipelines with overlapping service areas have large differences. For example the same survey indicated that, while local distributors paid an average price of $5.40 per Mcf to Great Lakes Transmission, whose service area includes Michigan, Wisconsin, and Minnesota, distributors paid an average of $3.65 per Mcf to Northern Natural Gas Company, whose deliveries serve the same states and others in the Midwest. Obviously, these pipelines have not had equal need to purchase high cost supplies to date, and they are not going to be equally capable of acquiring new gas supplies over the next several years.

c. Impact on End Users

The rising prices paid by interstate pipelines for natural gas are promptly passed through to customers through rate increases pursuant to purchased gas adjustment ("PGA") rate mechanisms. Many PGA increases have been extremely large under the NGPA. For example, Columbia Gas Transmission Corporation, which serves eight midwestern and eastern states, filed for PGA increases of $0.58 and $0.75 per Mcf in 1981, and for PGA increases of $0.40 per MMBtu and over $0.80 MMBtu in 1982. Moreover, it has informed its customers that they can expect another increase of $0.42 per MMBtu in March 1983. Similarly, Southern Natural had PGA increases of $0.60 and $0.45 per Mcf in 1981 and $0.13 per Mcf in January 1982, and it requested another $0.18 increase in its July 1982 filing. Large general rate increases have also been imposed during the same period. Not surprisingly, according to a July 1982 Energy User News survey, average retail gas rates have risen by 19% over the last year, even while average retail energy prices overall remained unchanged. */

The ultimate effect of the bidding for Section 107 gas and the uneven distribution of the old gas cushion is that retail rates for natural gas vary by large sums all over the country. For example, an Energy User News survey of March, 1982 retail rates in eight cities shows that residential rates varied widely, e.g., from $3.85/Mcf in Los Angeles to $4.26/Mcf in Chicago and from $6.37/Mcf in Atlanta to $8.64/Mcf in New York City. A similar survey of retail rates in eight other cities during December 1981, reached comparable results, with residential gas prices ranging from $4.00/Mcf in San Francisco to $5.66/Mcf in Philadelphia to $7.91/Mcf in Boston.

As a result of these disparities, industrials can face very different gas costs for no reason other than fortuitous differences in the price and supply of gas in their areas.

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*/ One PGC member, served in Ohio through the Columbia Gas system, reports that, compared to its average 1978 gas price of $2.17/Mcf, it last month paid $4.50/Mcf, and, under announced rate increases, will pay $6.04/Mcf beginning in March 1983. Other PGC member plants have experienced comparable price increases since the NGPA was enacted: a plant in Kansas City paid an average of $1.11/Mcf in 1978 and $3.59/Mcf in June 1982; a plant in southern California paid $2.28/Mcf in 1978, as compared to $5.41/Mcf last month; and a Baltimore plant which paid $2.47/Mcf in 1978 paid $5.21/Mcf last month.

B. Contract Problems

The extraordinary Section 107 prices tell only part of the story. Like many others, the Industrial Groups believe that there is a serious and growing market problem under the NGPA, commonly referred to as the "contract problem." The contract problems is already causing soaring deregulated gas costs, significant market losses and mounting take-or-pay obligations. Nevertheless, the greatest effects of this problem will not actually be felt until substantial new volumes of gas are deregulated in 1985.

The contract problem stems from the fact that the lion's share of gas purchase contracts entered into by pipelines since April 20, 1977, contain unreasonable price escalator terms and extremely high take-or-pay obligations. The latter clauses compel payment of the rapidly escalating prices, even when resale markets are falling, thereby shielding producers from the pressure of normal market forces.

Favored nations, commodity price and definite pricing formulae are at the center of the "contract problem." "Most favored nation" clauses require gas prices to continue rising to match the highest prices being paid under other contracts for gas in a specified area (which in some contracts may include as many as seven states and two foreign countries). A second type of indefinite price escalator is the so-called commodity escalator which ties post-deregulation prices to unrealistic levels, such as 110% of the retail price of expensive No. 2 fuel oil. Some gas contracts have both "most favored nation" and commodity escalator provisions, as well as fixed minimum price terms defined by formula. The latter "definite" pricing clauses frequently establish price floors which are themselves above long-term market clearing levels. In short, the contract problem arises from the fact that commodity escalators and definite pricing clauses could trigger the operation of virtually all the "most favored nation" clauses in contracts for gas to be deregulated in 1985, creating a domino effect of prices far above market-clearing levels.

According to a recent DOE survey, these extreme pricing clauses are pervasive in contracts for gas to be deregulated in 1985. For example, that survey reveals that of Section 102 contracts signed by interstate pipelines, 87.5 percent contain favored nation clauses; 33 percent contain commodity escalators linked to oil prices; 50 percent specify minimum prices; and only 13.5 percent contain market-out clauses. */

The result of these dubious contract terms will likely be an extraordinary jolt in 1985, when prices under thousands of Section 102, 103, 105, and 106 contracts will be deregulated under the NGPA. At that point, virtually every pipeline in

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*/ See "Natural Gas Producer/Purchaser Contracts and Their Potential Impacts on the Natural Gas Market" (DOE/EIA-0330, June 1982).

every state will suddenly have to reckon with price escalations whose impacts they may have grossly underestimated when signing gas contracts in the early 1980's. At least one pipeline -- Columbia -- is already encountering this contract problem because its Section 107 contracts have cost it more than it may have anticipated and because it failed to make adequate provisions for exercising market-out clauses prior to 1985. Moreover, even when it can exercise market-out clauses in some of its Section 107 contracts in 1985, it will still face large price increases in its Section 102 contracts, most of which lack such clauses.

Over and above the price clauses, most new gas contracts contain "take-or-pay" clauses which require pipelines to pay for 85% to 90% of the supplies tendered by the producer in any month or year, even when the buyer has no need for those supplies because of cheaper alternatives. These clauses often force pipelines to try to dump gas off-system or under electric utility boilers just to avoid prepayment penalties. */ Onerous take-or-pay terms in new high cost gas contracts can also force pipelines to cut back on purchases from much cheaper gas sources, as Columbia has done in Ohio.

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*/ For example, according to 1982 filings by the various pipelines, Transco estimates its potential take-or-pay liabilities at $451 million, Natural Gas Pipeline projects $174 million, Southern Natural estimates $175 million, Tennessee projects $152 million, and Columbia forecasts potential take-or-pay liabilities of $138 million.

To illustrate the combined effect of these clauses, consider a contract between Chevron and Columbia Gas Transmission in the Rocky Mountain Overthrust area. This contract requires Columbia to pay the highest of (1) a formula price that will go from $10.32 per Mcf on 1/1/85 to $18.75 per Mcf on 1/1/90, (2) 110% of No. 2 oil in New York City, or (3) the average of the highest prices paid in any two contracts in a seven-state area. Even though another contract clause ostensibly permits price renegotiations to relieve either party from extraordinary hardships, presumably including the pipeline's inability to resell the gas, that renegotiation clause would not permit the price ever to go below the formula price (i.e., $10.32 per Mcf on 1/1/85). However, even that limited "market-out" clause can be invoked only once every five years. Moreover, under its take-or-pay commitments, Columbia will also have to pay for 90% of the gas offered by the seller, regardless of whether its customers need or want those high cost supplies. This contract cannot be dismissed as an aberration since Columbia has reported that it made an identical offer on another producer's gas in the same area and lost the gas to a higher bid by another pipeline.

A recent study conducted by the DOE's Energy Information Administration (EIA), moreover, reveals that there will indeed be a serious possibility of alarming gas price increases under existing contracts in 1985. This study, which was based upon an extensive survey of natural gas contracts, is described in the report "Natural Gas Producer/Purchaser Contracts and Their Potential Impacts on the Natural Gas Market" (DOE/EIA-0330, June 1982). It projects that, if existing contracts are honored in 1985, there will gas cost increases of $7.3 billion (with a range of $3.6 billion to $16.5 billion) in 1980 dollars, with unit cost increases of $.44 per MMbtu in the interstate market (with a range of $.21 to $.84) in 1980 dollars.

C. Is the Market Correcting Itself?

Some may contend that there will be no "spike" in 1985, and that the market is already working out problems previously thought to require Administrative or Congressional action. There are some indications, for example, that the trend of extraordinary Section 107 prices may have started to change. First, as oil prices have softened, gas prices linked to oil have also declined. Second, three interstate pipelines -- Transcontinental Gas Pipe Line, Michigan Wisconsin Pipeline, and United Gas Pipe Line -- have recently invoked "market-out" clauses, to the extent they have them in their contracts to purchase deregulated gas. Under these contractual provisions, the pipelines notified their suppliers that contract prices for deregulated gas are so high that the gas cannot be marketed to end-users. In these notices, Transco stated that it would pay no more than $5.00 per MMBtu, Mich-Wisc stated that it would pay $6.00 per MMBtu, and United has established a ceiling of $5.73 per MMBtu. */

While some have interpreted these events as heralding the market's working out of its own problems, the Industrial Groups are less confident. First, the price declines attributable to oil price fluctuations are strictly transitory and will be offset if and when oil markets tighten up. Second, while three pipelines have wisely taken advantage of current market conditions to insist on price reductions to more realistic levels, others have not yet acted and may not act unless the FERC presses them to do so. **/ Third, a significant number of Section 107 contracts lack effective "market-out" clauses, and a large majority of Section 102 contracts (covering gas that will be deregulated in 1985) are also deficient in this respect. As a result, contrary to the recent positive events cited, gas prices may not go down in many contracts, and severe price increases could still occur in many instances.

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*/ Generally, the producers were allowed 30 to 90 days either to accept these prices or to terminate their contracts. Subsequent reports indicated that a substantial number of Transco's suppliers have agreed to the price reduction, although some have cancelled their contracts with Transco. Little information has been published on Mich Wisc's experience, and it is too early to tell about United.

**/ The Commission's stated willingness to tolerate extreme Section 107 gas costs even in the face of contract clauses which permit the pipeline to pay lower prices has not been helpful in this regard, particularly since so many pipelines have sizable investments in their own Section 107 gas production. See generally Order of June 30, 1982, Tennessee Gas Pipeline Co. (a Division of Tenneco, Inc.) Docket No. TA82-2-9-000.

Thus, the argument that the market will correct itself is persuasive only if one assumes (1) that the economy will not begin to recover anytime soon, (2) that world oil prices will remain soft for the duration, (3) that all pipelines will refuse to pay perversely-high prices for deregulated gas, and (4) either that pipelines will invite massive law suits or that producers (and royalty owners) will readily agree to eliminate contract terms which are highly favorable and even require payment for unneeded gas. Unless all of these assumptions are correct -- and the Industrial Groups strongly doubt that they are -- one cannot safely expect problems under the NGPA to work themselves out. Instead, gas consumers and utilities will continue to face a vicious circle of unmarketable gas, lost loads, higher unit fixed charges (and take-or-pay charges), more unmarketable gas, and so on. In that atmosphere, substantial pressure will be placed on Congress to extend gas price controls, even though such a "quick fix" would only worsen the longer run problems of supply, demand and price. Accordingly, ameliorative action is needed promptly; and the Industrial Groups believe that now -- while short-term supply appears to overbalance short-term demand -- is the time when such action can be taken with the least dislocation to the natural gas market.

IV. WELLHEAD PRICES

A. Old Gas Prices.

1. The NOI Proposals.

The NOI seeks comment on several proposals for raising the ceiling price of old, flowing gas. Such gas is regulated under Sections 104 (existing interstate contracts), 106 (interstate and intrastate rollover contracts) and 109 (miscellaneous gas). A Staff Analysis set forth in Appendix A of the NOI describes proposals that the Commission utilize the authority granted to it in each of those sections to establish a higher ceiling price under its authority to establish just and reasonable rates under the Natural Gas Act. Further details concerning these proposals are set forth in a Technical Report issued by the Staff on June 3, 1982. Overall, four separate proposals are discussed in the NOI. They are:

(1) Eliminate vintaging and establish a single just and reasonable rate for all old interstate gas equal to the highest Section 104 rate ($2.20/MMBtu in August 1982). A variant would be to reduce the "vintages" to fewer than the present number while raising rates. Staff concludes that the Commission "probably" has authority to take these steps.

(2) Revise upward the current just and reasonable rate for post-1974 gas previously adopted in Opinion No. 770-A */ and incorporated in the NGPA, based on current cost and production data.

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*/ 56 FPC 2698 (1976) aff'd The Second National Natural Gas Rate Cases, 567 F.2d 1016 (D.C. Cir. 1977), cert. denied, 435 U.S. 907 (1978).

(3) Establish a rate based on a hybrid cost-of-service/commodity-value approach. Market value would be one factor in setting cost-based rates, and would be given increased weight compared to previous area or national rate determinations. The NOI refers to this as a "new methodology in light of the differences in regulation brought about by the NGPA."

(4) Base just and reasonable rates on commodity value alone. The Staff analysis states that the FERC "may have authority" to do so, but it "probably did not have such authority prior to the NGPA."

What rate would result from these four proposals is a subject on which the Commission invites comment. The Staff Technical Analysis published in June indicates that a cost-of-service rate based on the Opinion No. 770 Methodology (Option (2) above) would result in prices of up to $7.36 to $8.13 per Mcf in 1981. This is well above the current price of Section 102 gas ($3.17 in August 1982) and well above the price of competing fuels such as low sulfur residual fuel oil. If this analysis is correct, a cost-of-service approach might yield a rate in excess of a commodity value rate -- a reversal of the traditional pattern of wellhead price regulation under the Natural Gas Act. The cost impact on consumers of any particular just and reasonable rate, moreover, would depend on the volume of gas made eligible for the rate. This in turn depends on whether and to what extent the Commission will eliminate vintaging for older wells.

A separate proposal concerning wellhead price increases for old gas was made by the Industrial Groups and is briefly noted in the NOI. Under that proposal there would be no increase in the price of old gas unless a producer agreed to renegotiate certain features in contracts for gas subject to deregulation in 1985. This proposal is distinctly different from the other proposals discussed in the NOI because the Commission proposals would raise old gas prices without seeking any quid pro quo with respect to prices of new gas.

2. Standards Which Should Be Applied in Evaluating Old Gas Price Increases.

The Industrial Groups respectfully submit that three standards should control any administrative decision to increase old gas prices. Paraphrasing Judge Leventhal in Public Service Commission of New York v. FERC, 589 F.2d 542, 550 (D.C. Cir. 1978), there must be: (1) a "demonstrable connection" between the price increase proposed and the alleged benefit to the consumer that it will produce; (2) "coordination of the program under scrutiny with national ratemaking and other programs so that they create no conflicting or unnecessarily duplicating incentives"; and (3) "evidence of producers' actual costs." These standards, which have been applied in connection with incentive rate programs under the Natural Gas Act, */ are clearly

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*/ As the Court stated: "[W]e have elaborated several flexible principles of review applicable to these cases, which we discuss below but summarize here to provide an overall perspective. The basic tension in reviewing these FPC programs is that they

(Continued on next page)

appropriate to the rate proposals at issue here under the NGA and NGPA.

There has been a long history of Commission efforts to allow a higher just and reasonable rate in exchange for some alleged benefit to the public interest. Typically, these have involved incentive prices to encourage development of new gas sources or commitment of additional gas reserves to the interstate market. */ The need for a nexus between the price offered and the benefit to the public has been stated a number of ways: that there must be a "*quid pro quo*" for the extra funding, **/

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provide producers with rates in excess of those found to be 'just and reasonable' under the nationwide ratemaking proceedings. In return, these ancillary programs, according to the FPC, encourage producers to engage in additional exploration and development of vitally needed new gas sources. We have upheld these programs if they satisfy three principles. There must be substantial evidence showing a *demonstrable connection* between the funding in the program under scrutiny and the increased gas supply which it will allegedly produce. There must be some minimum level of coordination of the program under scrutiny with national ratemaking and other programs so that they create no conflicting or unnecessarily duplicating incentives. Lastly, there must be evidence of producers' actual costs so that it can be determined whether the additional funding results in profits too huge to be reconcilable with the legislative command." 589 F.2d at 550.

*/ See *Mobil Oil Corp. v. FPC*, 417 U.S. 283, 316-17 (1974) (contingent escalations and refund work off credits); *Public Service Commission v. FPC*, 511 F.2d 338 (D.C. Cir. 1975) (advance payments); *FPC v. Texaco Inc.*, 417 U.S. 380 (1974) (deregulation of small producers); *The Second National Natural Gas Rate Cases*, 567 F.2d 1016 (D.C. Cir. 1977), *cert. denied*, 435 U.S. 967 (1978) (special rates for renewal contracts); *Moss v. FPC*, 502 F.2d 461 (D.C. Cir. 1974), *rev'd on other grounds* 424 U.S. 494 (1976) (optional certificate procedure).

**/ *The Second National Natural Gas Rate Cases*, *supra*, 567 F.2d at 1059-1060.

that there must be "symmetry" between the funding and increase in production, */, or that there must be a "direct connection" between the two. **/ A similar relationship must be demonstrated here.

The Industrial Groups oppose an increase in old gas prices unless there is a demonstrable connection between the increase and any alleged benefit to consumers. The Industrial Groups' proposal is designed to make such a connection crystal clear by tying any "old gas" increase to a producer's renegotiation of harmful clauses in contracts for new or deregulated gas contracts.

In contrast, the NOI suggests vaguely that increasing old gas prices without any conditions will benefit consumers simply by providing a "smoother transition to partial decontrol" (NOI at 29). Unfortunately, the benefit alleged by the FERC is not only quite speculative, but it is contrary to common sense for some pipelines unless the contract problem is also resolved. For example, the NOI asks whether increasing old gas prices would reduce the bidding advantages of some pipelines based on their relatively large cushions of old gas. No doubt it would; but, unless there is a simultaneous resolution of the contract problem, raising old gas prices might also cause serious economic hardships for pipelines that committed to high prices for deregulated gas prior to the time an increase in old gas prices was anticipated. Thus, if a pipeline's gas acquisition costs now result in a retail gas rate at the burnertip approaching the level of competing fuels (as appears to be, or soon will be, the case in some areas of the country), increasing old gas prices may push retail rates above competitive market prices, both before and after January 1, 1985. That, in turn, would force the pipeline: (1) to accept overall higher costs, inevitable load loss, and take-or-pay problems, or (2) to invoke market-out clauses -- to the extent that it can -- in high price gas contracts, thus risking loss of gas to pipelines with lower gas acquisition costs.

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*/ Public Service Comm'n v. FPC, supra, 511 F.2d at 347.

**/ Public Service Comm'n v. FERC, supra, 589 F.2d at 553.

In short, market disorder cannot be solved by changing old gas prices alone. Resolving the dilemma also requires other actions, particularly a remedy to the contract problem. Unless a price increase is tied to a solution to the contract problem, the Industrial Groups would strenuously oppose it.

Even if the rate proposals discussed in the Staff Analysis meet the "direct connection" standard set forth above, some of these proposals are deficient in other respects. The Staff Analysis concludes that the Commission "may have authority" under the NGPA to establish rates based on market or commodity value alone, without regard to actual producer costs. However, the NGPA incorporates the NGA ratemaking standards; and, under the "just and reasonble" standard of the NGA, the Commission clearly does not have authority to disregard costs.

As the Supreme Court has stated, "Congress could not have assumed that 'just and reasonable' rates could conclusively be determined by reference to market price." FPC v. Texaco, Inc., 417 U.S. 380, 399 (1973). The Commission may take into account non-cost factors in setting a just and reasonable rate, Mobil Oil Co. v. FPC, 417 U.S. 283, 317 (1973), but it cannot ignore cost entirely.

The second standard stated above -- avoiding inconsistency with national rate policies -- is perfectly applicable to producer ratemaking under the dual statutory scheme of the NGA and NGPA. The Staff Analysis violates this principle in suggesting that an appropriate just and reasonable rate might result in a ceiling price equal to or above the Section 102 (new gas) or Section 103 (new production well) price. This is the type of result that would turn the NGPA on its head and which should not be sanctioned.

Title I of the NGPA draws a basic distinction between old flowing interstate gas, which is to remain regulated indefinitely, and new gas which is to be deregulated in 1985. Prior to 1985, the regulated price of new gas is set at a higher level than that for old gas. Although this bifurcated price structure has been a primary source of market disorder, and although reducing the price disparity between the two types of gas may seem economically efficient, it was a vital element in the compromise that led to enactment of Title I. Cf. Pennzoil Co. v. FERC, 645

F.2d 360, 380 (5th Cir. 1981), cert. denied, 102 S.C. 1000 (1982). It is simply beyond the Commission's authority to eliminate this dual market. The Commission has even less authority to reverse the price structure mandated by NGPA by pricing old gas above the price of new gas. The Commission plainly may establish a new just and reasonable rate under Sections 104, 106 and 109, but it cannot do so in a way that would defeat the purpose of the NGPA. */

3. The Industrial Groups' Proposal.

To deal with these problems, the Industrial Groups propose that individual producers be permitted to receive higher ceiling prices for old gas now in exchange for renegotiating the deregulated price clauses in existing contracts covering equivalent volumes of either gas to be deregulated in 1985 or gas which is currently deregulated under Section 107. For gas deregulated in or after 1985, the producer would be

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*/ The Staff Technical Analysis, which suggests that the current just and reasonable rate for old gas exceeds the highest NGPA ceiling prices for new gas, may also fail to account fully for the relationship between the NGPA and NGA. The rate methodology employed in the Technical Analysis is based on court approved methods for measuring well-drilling costs in the pre-NGPA era. Under the NGPA, however, pricing incentives not available under the NGA have spurred drilling in many difficult and costly locations. To the extent that the Staff is basing average costs for Section 104 wells on costs incurred for new wells drilled under Sections 102, 103 or even 107, its methodology may yield a different, higher rate than would be derived had the NGPA not been enacted. This is the type of "double-counting" of high cost gas projects which the Court warned against in the context of incentive programs under the NGA. See Public Service Comm. v. FERC, supra, 589 F.2d at 560-562.

required to limit indefinite escalator clauses or definite escalator clauses so that the contract price would not rise above a reasonable market price after deregulation. For these purposes, the market price would be determined by the Commission (e.g., based on some multiple of oil prices). Alternatively, the Commission could permit a producer of old gas to receive up to the higher ceiling price if the producer and his pipeline purchaser agreed to substitute open-ended renegotiation clauses for all automatic (definite and indefinite) escalation clauses in the relevant contracts for new gas. */ For currently deregulated gas that is not already subject to a market-out clause, the Commission could likewise require either (1) the capping the price of such new gas at a long-term market clearing level or (2) the replacement of automatic escalator clauses with a general renegotiation clause.

Under these conditions, the Commission's "just and reasonable" determination for such old gas would be based, in

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*/ An appropriate renegotiation clause would have to provide that either party could seek renegotiation of the price to reflect prevailing market conditions. Failing to agree, either party could seek arbitration or, possibly, cancellation of the contract. Presumably, a provision would have to be made for the pipeline to continue to provide transportation services, under a cost-of-service rate, in the event a new agreement could not be reached and the producer sold the gas to a different buyer. It might also be appropriate to give the pipeline a right of first refusal to match contract terms contained in a bona fide offer by another potential buyer. The point is to give both parties to the contract as much freedom as possible to find an acceptable price reflecting prevailing market conditions, unencumbered by distorted pricing terms negotiated during the pre-deregulation period.

part, on the recognition that a smoother transition to deregulation, with less rapid price increases after deregulation, can save consumers money in the long run. Producers, on the other hand, would receive a present economic gain, in exchange for agreeing to forgo a potential later economic windfall. It is not simply a matter of trading higher prices later for higher prices now. The problems which may occur in 1985 and thereafter threaten substantial adverse impacts to the interests of consumers. If increasing old gas prices now can be conditioned in a way to reduce these impacts, the price increases might be justified under the Natural Gas Act and the NGPA.

Under this proposal, the higher prices would be available to all interstate gas covered by Sections 104, 106 and 109 of the NGPA, provided that the necessary conditions were met. Whether the program should also be extended to intrastate rollover contracts subject to the just and reasonable standard under NGPA Section 106, is a question that could be decided after receiving comments on the proposal.

Of course, Section 101 of the NGPA provides that no maximum lawful price shall supersede a lower price provided in any applicable contract. In this vein, the Industrial Groups certainly propose that any incentive price applicable under this program be collectible only to the extent permitted by contract, including lawful amendments thereto.

4. Legality of the Proposal.

There is ample precedent under both the Natural Gas Act and NGPA for establishing an incentive price for selected producers in exchange for their foregoing indefinite price escalator clauses. The general authority to establish incentive rates for selected producers has been affirmed by the Supreme Court.

> "Nothing in the purposes or history of the [Natural Gas] Act forbids the Commission to require different prices for different sales, even if the distinctions are unrelated to quality, if these arrangements are 'necessary or appropriate to carry out the provisions of this Act' . . . . We hold that the statutory 'just and reasonable' standard permits the Commission to require differences in price for simultaneous sales of gas of identical quality, if it has permissibly found that such differences will effectively serve the regulatory purposes contemplated by Congress."

Permian Basin Area Rate Cases, 390 U.S. 747, 796-798 (1968); Mobil Oil Corp. v. FPC, supra, 417 U.S. at 317.

The argument that there is only one just and reasonable rate applicable to all producers and that the Commission cannot differentiate among producers for rate pruposes was rejected in both Permian and Mobil. As the Court stated in Mobil:

> "Mobil [argues] that there is only one just and reasonable rate possible for each vintage of gas . . . . We rejected this argument in Permian Basin and we reject it again here." 417 U.S. at 317. */

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*/ The Natural Gas Act does not forbid all differences in setting rates. Rather, it forbids undue discrimination. Incentive rates for selected producers have consistently been found lawful under the discrimination standards of NGA Section 4.

Under the Natural Gas Act, the primary regulatory purpose which has justified incentive rates has been the enhancement of interstate gas supplies. */ The enactment of the NGPA, moreover, suggests additional regulatory purposes which might justify an incentive rate. A principal purpose of the NGPA, as the Commission has repeatedly noted, **/ was to assure a smooth transition to decontrol. Nevertheless, events subsequent to enactment of the NGPA have threatened to frustrate this Congressional intent. As the Commission stated in its "Statement of Policy" (at pp. 23-24):

> "The NPGA was intended to achieve a smooth transition to decontrol . . . . However, given market events since passage of the NGPA [and] . . . the price spike that will be created by the NGPA, the transition to substantially increased partial decontrol in 1985 is likely to be far from smooth."

Under these circumstances, it would be reasonable for the Commission to exercise its power to establish just and reasonable rates under Sections 104, 106 and 109 of the NGPA and Sections 4 and 5 of the NGA for the purpose of smoothing the transition to decontrol. A smooth transition to decontrol would serve the interests of consumers producers, pipelines, and distributors, and it is therefore a legitimate goal of regulatory pricing policy under the dual statutory scheme created by the NGPA and NGA.

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*/ "The Commission may . . . . employ price functionally in order to achieve relevant regulatory purposes; it may, in particular, take fully into account the probable consequences of a given price level for future programs of exploration and production." Permian Basin Area Rate Cases, supra, 390 U.S. at 796-798; Mobil Oil Corp. v. FPC, supra, 417 U.S. at 317.

**/ NOI at 11; Statement of Policy at 23-24.

Significantly, there is direct Commission precedent both for restricting the use of indefinite escalator clauses and most favored nations clauses in gas subject to price regulation under the NGA, */ and for placing conditions on incentive prices in order to eliminate open-ended price terms. For example, in the late 1950's, the Commission in "numerous cases" accepted increased rates higher than the approved area rates in exchange for elimination of price-redetermination and favored-nation provisions. Statement of General Policy No. 61-1, 24 FPC 818, (1960); Second Amendment to Statement of General Policy No. 61-1, 24 F.P.C. 1107, 1108 (1960). Similarly, in 1974, the Courts approved an optional certificate procedure under which a producer must, as a condition of employing the procedure, forego indefinite or area pricing clauses. The D.C. Circuit stated:

> "The Commission may of course make rules prohibiting certain pricing clauses in contracts to be certificated . . . .; and the Commission has consistently held that indefinite pricing clauses are contrary to the public interest . . . .

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*/ Order No. 174-B, 13 F.P.C. 1576 (Dec. 17, 1954); Order No. 232, 257 F.P.C. 379 (March 3, 1961); Order No. 232-A, 25 F.P.C. 609 (March 31, 1961); Order No. 242, 27 F.P.C. 339, (Feb. 8, 1962). See Superior Oil Co. v. FPC, 322 F.2d 601 (9th Cir. 1963), cert. denied, 377 U.S. 922 (1964); FPC v. Texaco, Inc., 377 U.S. 33 (1964). See generally, Pennzoil Co. v. FERC, 645 F.2d 360, 365-367 (5th Cir. 1981) cert. denied, 102 S.C. 1000 (1982); 4 H. Williams & C. Meyers, Oil & Gas Law, §726.1 at 763-769 (1977).

> "Here the Commission is endeavoring to provide the producers with some measure of price certainty and stability. To accomplish that end the Commission offers an optional procedure under which producers may elect not to adhere to area price ceilings. It is reasonable to make the 'area rate' clauses unavailable to a producer who by [relying on an indefinite rate clause] elects not to adhere to the area ceilings."

Moss v. FPC, 502 F.2d 461, 471 (D.C. Cir. 1974), rev'd on other grounds, 424 U.S. 494 (1976).

Another relevant precedent can be found in the Commission's "incentive price" rule for "tight sands" gas under NGPA Section 107. There, the Commission ruled that gas sold under contracts containing certain types of escalators would be ineligible, and it limited availability of the special price to contracts providing for a specified fixed rate, a rate determined under a fixed escalator clause, or a rate based on an FERC approved rate. The 5th Circuit upheld this so-called "negotiated contract price requirement" against challenges by producers that it imposed an unlawful condition precedent to collection of a maximum lawful price to which they were entitled. The Court stated:

> "[T]his Court, like the FERC, rejects [this argument] as premised on a misconception of the function of the negotiated contract price requirement in the incentive price regulatory scheme. The requirement does not act to deny collection of a price for which the gas qualifies under controlling definitional criteria; rather, the history of its development shows clearly that it is itself a part of the definition of gas entitled to the special incentive price. The requirement was promulgated . . . in

> satisfaction of [FERC's] duty to define the gas qualifying for that special price in a manner consonant with the express mandate of the [NGPA]."

Pennzoil Co. v. FERC, 671 F.2d 119, 125 (5th Cir. 1982) (Emphasis added).

The Pennzoil case stands squarely for the proposition that the Commission may exercise its wellhead pricing authority under the NGPA (e.g., under Section 104) so as to condition an incentive price on the elimination of indefinite escalator clauses, provided it serves a reasonable regulatory purpose. As the Court stated:

> "in looking to contractual terms to determine whether the gas sold thereunder qualified for a particular price classification [the FERC] could dictate the effect to be given these terms, so long as that effect was reasonably calculated to further its legitimate regulatory policies . . . . The pertinent question, then, is whether FERC in limiting eligibility for the Section 107 price to gas sold pursuant to contracts containing only certain pricing provisions, was acting in a manner reasonably calculated to further its legitimate regulatory policy." (Id. at 127 (emphasis in original)).

See generally, Superior Oil Co. v. FERC, 569 F.2d 971 (5th Cir.), cert. denied, 439 U.S. 834 (1978).

Moreover, granting an incentive price to producers of regulated Section 104 gas in exchange for their renegotiating unregulated Section 107 gas prices or post-1984 deregulated prices for gas in other categories, such as Sections 102 and 103, would not constitute regulation of deregulated sales, even if the Commission placed conditions on the renegotiated contracts. Rather, the Commission would simply be exercising its power to set a just and reasonable rate under Section 104 and to define the eligibility for that rate. Whether pipelines and producers availed themselves of the higher prices offered under the program would be left to them.

In sum, the Industrial Groups respectfully submit that its proposal for increasing old gas prices would be lawful under the _Pennzoil_ decision and the test announced by Judge Leventhal in _Public Service Commission v. FERC_, _supra_. _First_, it would be founded on a demonstrable connection between the price increase and the benefit to the consumer because the renegotiated contract would be a condition precedent to receiving a higher rate. _Second_, it would be consistent with the purposes of the NGPA because it would be designed to achieve a smooth transition to decontrol, a prime goal of Congress in enacting Title I. And, _third_, the old gas rate would be based to some extent on cost factors and would have to be determined to be just and reasonable.

5. _Program Implementation_

Under the proposal, an incentive price would be available for volumes of old gas, provided that the relevant producer and pipeline first renegotiated contracts within the parameters of the rule, on an equivalent volume of gas to be deregulated before or after January 1, 1985. Participation in the program would be voluntary and neither producers not pipelines could be compelled to alter existing agreements. Before the higher price could be charged for the "old gas," the producer and pipeline would have to make a showing that appropriate modifications had been made in the "new gas" contracts. This showing could be accomplished through the filing of affidavits and the new and old contract terms.

Ideally, the higher old gas rate would be the rate necessary to achieve a significant renegotiation of new gas contracts, without paying producers more than the value to the public of the revised new gas prices. The value to the public (like the cost to a producer) of removing an indefinite escalator clause from a contract subject to deregulation in 1985 is probably quite substantial, but difficult to quantify. It seems inevitable, therefore, that the Commission would be required to exercise its informed judgment as to the level of incentive price required to produce the desired producer response. The Commission has successfully exercised similar judgment in prior rate cases in calculating the rate necessary to bring forth new supplies or to induce greater commitments to the interstate market. See Mobil Oil Co., supra. Although we do not suggest precisely what the just and reasonable rate should be, it should be below the Section 102 and 103 prices and below any surrogate market clearing price determined by the Commission, if that price is lower than the Section 103 price.

Of course, pipelines and producers would be free to negotiate a price below the maximum level established by the rule.

Three obvious questions arise concerning this proposal: (1) Would this make some pipielines worse off? (2) How can one best match volumes of old and new gas, given the fact that a pipeline may purchase old gas from one producer and new gas from another? (3) What can be done about pipelines with relatively small old gas cushions? Admittedly, a comprehensive solution requires legislation, and there is no perfect administrative solution for either problem. However, absent sound legislation, a reasonably good resolution may be achieved.

First, under such a program, pipelines would be free to agree or not agree to exchange a higher old gas price for a lower potential new gas price. In effect, each pipeline would be told that it can pay "x" amount more for old gas, provided that it negotiates deals adequate to resolve or significantly mitigate its contract problems with new gas, under standards prescribed by the Commission. Depending on the particular contracts involved (e.g., a very cheap old gas contract or a less severe new gas contract), the pipeline may be able to resolve the problems in a particular new gas contract by paying less than the maximum increase in the old gas price. The major restrictions would be: (1) the volumes of old gas achieving the maximum price could not exceed the volumes of renegotiated new gas; */ (2) the resulting amendments to contracts for new gas would have to meet prescribed standards; and (3) the pipeline would have to be able to show that it acted prudently in agreeing to pay higher old gas prices, if challenged in particular instances. **/

Second, the problem of matching old and new gas producers could conceivably be resolved through three-way transactions. For example, assume that Pipeline A buys old gas from Producer B and new gas from Producer C. Pipeline A might be able to arrange a three-party transaction in which the old gas producer, B, makes a payment to C (in effect sharing the incentive price) in order to induce C to eliminate indefinite escalators in his new gas contract with A. Presumably, C could not receive any portion of the incentive payment before January 1, 1985, since the extra payment might be treated as a premium for flowing gas above the NGPA ceiling price. However, C could agree to receive payments from Producer B after partial deregulation occurs on January 1, 1985 (*e.g.*, in a lump sum or over time) in exchange for agreeing to modify the pricing terms which will be effective after C's sale under an existing contract is deregulated. */ Nothing in the NGPA limits the manner in which payments are made for deregulated gas (absent fraud, abuse or similar violations of duties).

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*/ An estimate of reserves based on Form 15 would be one possible basis for comparing volumes covered by different contracts.

**/ Because the old gas would continue to be subject to the Natural Gas Act's "just and reasonable" standard, there would be no barrier to the Commission's adopting a "prudence" requirement as part of its definition of the higher "just and reasonable" price.

Third, there may be little the Commission can do about the fact that some pipelines have less old gas than others. Those pipelines would simply have to do the best they could with the limited old gas volumes available. For example, if unable to match old gas and new gas on a volumetric basis, the pipeline might be able to persuade the relevant producers that a present increase in the price applicable to smaller volumes of old gas (with the assurance of passthrough) would be better than a gamble on obtaining a higher-than-market price on larger volumes of new gas later. This may be possible because producers, too, must have some uncertainty about their ability to obtain above-market prices for very long on any categories of gas. Alternatively, a pipeline might simply go after its most dangerous contracts. For example, a pipeline would presumably first attempt to neutralize contracts containing extreme definite price escalators or commodity-type indefinite escalators (e.g., pegged to No. 2 oil prices). **/ If these were successfully transformed into renegotiation clauses designed to achieve true market prices, then favored nations clauses would pose substantially less danger. */

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*/ Because the purpose of the program would be to resolve potentially severe problems in previously negotiated contracts, the program would have to be limited to contracts for new gas signed before the rule was proposed. Otherwise, new contracts for "new" gas might be written specifically in order to obtain higher "old" gas prices through the back door.

**/ Obviously, a pipeline would have no reason to seek modification of contracts which already contain market-out clauses.

In effect, under this scheme, the pipelines would have some bargaining power, in the form of potentially higher old gas prices, to permit them to renegotiate contracts which would disrupt the transition into deregulation. The system would offer the advantage of flexibility and it would permit the parties that have the best understanding of their potential difficulties greater freedom to resolve their problems. Of course, for the program to work well, it would have to be clear that, upon deregulation in 1985, the pipeline's own money will be at risk if gas prices are too high to permit to resell all of its supplies. Only that clear economic message will assure that pipelines take every reasonable step to deal with their contract problems.

B. Incentive Prices For High Cost Supplies

The Commission has legal authority under Section 107 (b) of the NGPA to prescribe higher than normal maximum lawful prices "to the extent that such special price is necessary to provide reasonable incentives for the production of such high-cost natural gas." For purposes of this provision, Section 107 (c)(5) defines "high-cost natural gas" to mean gas "produced

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*/ NGPA Section 313 prohibits prices paid for Section 107 gas from being taken into account in implementing indefinite escalators contained in any non-Section 107 contracts.

under. . . conditions. . . the Commission determines to present extraordinary risks or costs."

In their Petition for Rulemaking, the Industrial Groups recommended that the Commission exercise its authority under this section so as to mitigate market disorders. Although the NOI does not discuss these proposals, the Commission has, in other dockets, proposed adopting certain "incentive prices." The Commission has exercised its authority under this section to adopt special incentive prices for gas produced from "tight sands". */ It has also proposed rules to provide incentive prices for off-shore wells drilled in water deeper than 200 feet and for gas produced from wells drilled to depths between 10,000 and 15,000 feet. **/ While the Commission has received comments, it has not yet acted on either of the latter two proposals.

The Industrial Groups submit that, by properly utilizing its incentive price authority, the Commission can materially assist in smoothing the transition to deregulation. It can do so both by providing incentives to explore for additional supplies and by properly conditioning the incentive prices so that qualifying supplies do not contribute to the post-deregulation contract problems which have been described previously in these comments. The additional supplies developed by such incentives will help to meet market demands and will help to keep post-deregulation prices down.

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*/ 18 C.F.R. §271.703.

**/ _See_ Notice of Proposed Rulemaking, "High-Cost Natural Gas Produced From Wells Drilled in Deep Water," 45 _Fed_. _Reg_. 47863 (July 17, 1980); Notice of Proposed Rulemaking, "High-Cost Natural Gas Produced From Intermediate Deep Drilling," 47 _Fed_. _Reg_. 638 (January 6, 1982).

Accordingly, the Industrial Groups urge the Commission (1) to adopt incentive price rules for both deep water and intermediate deep wells, as well as other categories of "high-cost natural gas," and (2) to modify the current tight sands incentive price rule, both as follows:

a. The Commission should set the maximum incentive price at a level equal to its best estimate of the wellhead gas price that would prevail in a free market. This floating incentive price should be adjusted and published on a periodic basis (at least semi-annually).

b. As part of its establishment of a reasonable incentive, the Commission should limit the availability of the incentive price to gas purchased under contracts which contain neither indefinite nor definite pricing clauses which could automatically establish any price higher than the incentive price following deregulation. */ However, the incentive price should be available for gas sold under contracts containing renegotiation clauses which would permit the parties voluntarily to renegotiate the price following deregulation. **/

c. As part of the its establishment of reasonable incentives, the Commission should require that qualifying contracts provide for moderation of the take-or-pay obligations as prices escalate.

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*/ As discussed elsewhere, extreme definite price escalators can pose as serious a problem as extreme indefinite pricing clauses both in individual contracts and as benchmarks for the operation of favored nation clauses in other contracts. For example, one pricing clause in a publicly available contract signed by Columbia Gas Transmission Corporation provides for the minimum deregulated price to begin at $6.40/MMBtu in December, 1980, with monthly escalations equal to the greater of 1% per month or the monthly inflation rate. (Indefinite escalators and the so-called market-out clause can never produce a lower price.) This "definite" escalation clause will, therefore, yield minimum prices of at least $10.32/MMBtu on January 1, 1985, rising to $18.75/MMBtu on January 1, 1990, and continuing to escalate thereafter. Other gas contracts are known to contain similar "definite" pricing terms. (Indeed, when Columbia offered identical contract terms to another producer, it failed to obtain the gas because it was outbid by another pipeline).

**/ Gas will not be deregulated in 1985 or 1987 merely because it is entitled to incentive prices, under Section 107(c)(5). However, to the extent it otherwise qualifies under NGPA Section 121(a) or (c) (e.g., as "new natural gas" or as gas from a "new, on-shore, production well"), gas benefiting from regulated incentive prices will be deregulated in the future.

1. Use of an Estimated Market Price

Offering a market-based price as an incentive under Section 107(b) should be sufficient to induce all the exploration and development which would occur in a functioning free market, without inducing wasteful investments in exploration for special sources of gas. This should suffice to achieve the Commission's supply objectives, since in a truly free market, ample drilling would result from the interplay of market forces, without unusually high prices for any particular type of supply. That is, the market price alone would be sufficient to do the job, and no purchaser would have any reason to pay above-market prices for any volumes of gas, absent unique circumstances. */

Unfortunately, the NGPA's vintaging structure creates the potential (which has been realized under Section 107 in many cases) for artifically high prices in narrow categories. Thus, if the Commission sets incentive prices for a particular category

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*/ In general, natural gas is a fungible commodity whose market value is no greater when produced from a high cost source as opposed to an easy to develop source. Consequently, in a free market, special prices could not result unless the seller could demonstrate that his product was not fungible but had unusually advantageous characteristics (*e.g.*, high Btu content). The mere fact that a given supply cost more to develop would not be sufficient to induce a higher price, only a lower profit for the producer. As a result, one would generally expect exploration and development to follow a relatively orderly path (subject to producers' uncertain knowledge of geology) beginning with the cheapest sources. One danger of a poorly constructed incentive price regulation scheme, such as Title I, is that it distorts that orderly developmental path and encourages wasteful investment in unnecessarily costly sources.

at an artificially high level -- e.g., one tied to some multiple of a constantly increasing regulated price -- the incentive prices paid by pipelines will likely reach the ceiling even if the ceiling is above long-term market clearing prices. Not only will this tend to induce uneconomic exploration and development patterns, the artificially high prices will carry over into the post-deregulation period, further complicating the transition to deregulation by increasing the number of deregulated contracts which have to be negotiated downward during the post-1984 period.

Developing a specific incentive price would necessarily require the Commission to make a judgment concerning the range of wellhead prices that would prevail in a truly free market. One commonly mentioned method for estimating free market price for gas at the wellhead is based upon oil refiners' weighted average acquisition cost of crude oil. Here, estimates of free market wellhead gas prices range from 60% to 80% of refiners' acquisition cost of crude oil. Part of the difficulty with using a fixed relationship to crude oil prices is the assumption that the current relationship between residual fuel oil prices and crude oil prices will remain constant over time. The validity of this assumption depends on a host of factors, ranging from the quality of crude oil being purchased to the demand for residual fuel oil as a function of the economy and industrial fuel switching from gas. Thus, to estimate market clearing prices for gas on this basis would require the Commission periodically to collect data both on the refiners' weighted average crude oil costs and on the relationship between average crude oil prices and average residual fuel oil prices. */ Although basing an incentive price on this methodology would necessarily entail some work, the administrative burden would not be great, since much of the needed data is routinely gathered by the Energy Information Admnistration already.

Another approach to estimation would be to try to relate the incentive price directly to prices paid by industrials for residual fuel oil. This approach would be premised on the common view that in a free market, retail competition between residual fuel oil and natural gas would be the principal determinant of natural gas wellhead prices. That is, for gas markets to clear, the wellhead price would have to be set so that the retail price -- reflecting the sum of the wellhead price and all delivery costs -- produces a balance between deliverable supply and market demand. **/ Translating these observations into an estimated free market price, however, would not be free from difficulty. Presumably a national average of residual fuel oil

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*/ Indeed, even in the last year, at least one gas trade association has significantly changed its estimate of the ratio of free market gas prices to crude oil prices.

**/ While many factors will affect the supply and balance, there is a large block of industrial and utility gas users that can readily switch to residual oil if gas prices go to high. Thus, to clear existing markets, gas must be marketable to these types of consumers. The proportion of total industrial energy

(Continued on next page)

prices would have to be used, although there would be some debate about the appropriate sulphur content to be used. Once an appropriate reference price is selected, an allowance would have to be made for transportation and distribution costs. Given the fact that natural gas is produced in significant quantities in places ranging from California to Ohio, and from Wyoming to Louisiana, and consumed throughout the country, transportation costs vary widely. Notwithstanding some uncertainties, FERC could probably calculate a reasonable approximation by developing estimates of average transportation and distribution costs on a national basis. That would then be subtracted from the retail residual oil price to produce the gas well price estimate. */

Properly implemented, either approach could yield an adequate estimate for establishing an incentive price ceiling for high cost gas, even though a perfect calculation would be impossible.

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demand which must be retained by gas in order to clear gas markets at the wellhead will fluctuate depending upon a variety of factors, such as overall industrial activity (i.e., the state of the economy) and the exploration and development practices of gas producers. Over the long-term, additional factors, such as increasing usage of coal and other alternative energy sources, will influence the free market price for natural gas. The equation is necessarily dynamic so that true deregulation is the only way to achieve long-term balance between supply and demand.

*/ Recognizing that oil prices fluctuate significantly over time, the estimated wellhead market clearing price should be adjusted either quarterly or semi-annually based upon updated information on residual fuel oil prices. Updating the estimated average transportation costs could be done less frequently.

2. Limitation on Contract Terms

Regardless of the method used to estimate the true market clearing price for gas, it is important that the Commission require producers to forego any indefinite escalation clauses or any definite escalation clauses which could automatically increase the wellhead price above market clearing upon deregulation in 1985. */ This restriction would help to mitigate the already-severe contract problems confronting pipelines and their customers. In any event, it would not be a "reasonable incentive" to give a producer a market clearing price today if he is going to capture an above-market clearing price in the future. If a producer wants to take his chances on receiving an above-market price after January 1, 1985 (or in 1987 for either some gas categories or generally if controls are extended), then he is free to take that risk, but it would not be reasonable to give him the benefit of market level prices in the meantime.

At the same time, the Industrial Groups recognize that, in the post-deregulation period, producers and pipelines should be free to renegotiate pricing terms to reflect actual market conditions then prevailing. They should not be forever locked-in to the Commission's estimates of a market clearing price. Consequently, the Industrial Groups have no objection

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*/ As noted in Part IV above, under Section 107(b), the Commission clearly has authority to limit eligibility for an incentive price to gas sold under contracts which lack indefinite price escalator clauses. See Pennzoil Co. v. FERC, supra, 671 F.2d 119 (5th Cir. 1982).

to affording the Section 107(b) incentive price to gas sold under contracts containing open-ended renegotiation clauses which permit the contracting parties freely to negotiate new pricing terms once deregulation has occurred. Under such clauses, either party could insist upon renegotiation of the pricing terms for any reason. If agreement on a new price could not be reached, then either party could back out of the contract and seek better terms elsewhere. Presumably, the contract would provide for transportation services by the pipeline, based on a cost-of-service rate, in case the producer got a better offer from another buyer; and the contract might provide the original purchaser with a right of first refusal to match other offers. Such a renegotiation clause would help to smooth the transition to decontrol by assuring that the deregulated prices accurately reflect actual market conditions, rather than prior estimates of market prices. */

Finally, in order to provide protection to both pipelines and producers, the Commission should require that, in order to qualify, gas must be sold under contracts with take-or-pay clauses which vary the take requirement according to changes in the price (not to exceed a specified maximum, such

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*/ Because there may be a tumultuous period in which many Section 102 and 107 contracts exceed market clearing levels and in which pipelines are trying to renegotiate contracts *en masse*, it might be reasonable to provide that the renegotiation clause may be triggered only after some reasonable time following deregulation (*e.g.*, six months).

as 85%-90%, under any circumstances). */ That is, if the price goes up, the take-or-pay level should go down. By adopting a sliding scale take-or-pay requirement, as suggested above, producers should be adequately assured of cash flow, while pipelines would be protected from having to pay increasing take-or-pay bills as rising prices cause them to lose more markets. Imposing such a restriction would also be consistent with the Commission's broad authority to establish reasonable incentives.

In sum, the Industrial Groups encourage the Commission to adopt reasonable rules allowing incentive prices, provided that such rules are based on market level prices and help to defuse the NGPA's potentially severe contract problems. This recommendation by the Industrial Groups applies to the Commission's two pending rulemakings -- the deep water proposal and the intermediate deep proposal -- and the Industrial Groups urge the Commission to modify the tight sands rule along the same lines. **/

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*/ See discussion at pages 65-70, *infra*. Although take-or-pay levels of 85% to 90% are extremely *high*, they may not be excessive if adopted by the parties as a ceiling on a sliding scale type of take-or-pay requirement.

*/ *See* footnote, page 50, *supra*.

V. PIPELINE PURCHASING PRACTICES

A. The Commission Can And Should Take Action To Ameliorate Take-Or-Pay Problems.

1. The Problem

The Commission can and should take action to protect consumers from the growing take-or-pay problems created by pipelines' contracts with producers. The problem arises because, for several years, gas purchase contracts with producers typically have combined automatic price escalators with exceedingly high take-or-pay requirements (85% to 90% of tendered volumes in most instances, and even 100%, on a temporary basis, in some cases). */ These problems have been compounded by the pipelines' failure accurately to assess the elasticity of their resale markets or the rapid price escalations to which they committed themselves. As a result of these failures, many pipelines have put themselves in the position of being squeezed by rapidly rising prices and declining resale markets. Already several interstate pipelines have made general rate filings asking to include in their rate bases large take-or-pay expenditures. **/

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*/ Many contracts for high cost gas, for example, have 85%-90% take-or-pay requirements, with 5-year make-up periods, and with the buyer obligated to pay the differences between the original price and the prevaling price at the time of make-up. Some contracts provide a 100% take-or-pay requirement for a period (*e.g.*, one year) followed by a lower obligation thereafter. (Many contracts also provide a 100% take-or-pay obligation for associated gas, without any make-up period, although there may be special justifications for that practice.)

**/ See footnote p. 24, *supra*.

The current problems, however, may reflect only the tip of the iceberg. Looking toward 1985, the take-or-pay problems will almost certainly get worse. As indefinite escalator clauses are triggered in 1985 by the deregulation of thousands of Section 102 and 103 contracts, gas prices will sharply increase, without any reductions in the obligation to pay for volumes not taken. When the inevitable loss of industrial and utility sales occurs in response to the sharply escalating prices, interstate pipelines will attempt to elevate unit rates to reflect (1) the higher cost of the flowing gas, (2) the larger share of the pipelines' fixed cost, and (3) the pipelines' additional take-or-pay costs. */ These escalating costs will create new hardships for customers left on the system and will induce still more fuel switching -- potentially permanent fuel switching by some customers. The latter responses will extend the destructive cycle as the loss of sales will compound the pipelines' take-or-pay costs and its concentration of facility costs on yet smaller sales volumes, which, in turn, will produce still further fuel switching and conservation. Interstate pipelines' markets may never fully recover from these load losses, which are already beginning.

These problems are occurring and will worsen, not because take-or-pay clauses are inherently destructive, but

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*/ Under existing regulations, take-or-pay costs are not passed through to customers via piplines' PGA clauses but are treated as working capital on which the pipeline earns a rate of return.

because of the extreme nature of the contracts signed by interstate pipelines in recent years. While 85% to 90% take-or-pay clauses might have seemed tolerable during an era of gas shortages in which there was never a problem with reselling gas, their unreasonableness became clear when the NGPA set gas markets on a course towards deregulation and market clearing. At that point, it became patently indefensible for interstate pipelines to contract to pay for 85%-90% (or even more) of tendered supplies, regardless of price and resale market resistance. The harm from such extreme take-or-pay clauses should have been particularly obvious with regard to deregulated contracts that contain extreme pricing clauses.

The pernicious effect of these contract terms is easily illustrated by the experience of one interstate pipeline which now claims to face imminent and severe take-or-pay problems. In 1979, Columbia signed contracts to purchase deep well gas at initial prices in the range of $2.25 to $2.50 per Mcf, combined with favored nation clauses and 85% take-or-pay commitments. A little over two years later, that pipeline was paying over $8 per Mcf for the same gas under the same extreme take-or-pay commitments. As a result, it saw nearly a fourfold increase in price without any diminution of its take-or-pay obligation. Undoubtedly, other interstate pipelines have seen similar price leaps, without having provided for amelioration of their take-or-pay obligations.

These are not the problems of pipelines and consumers only. The extreme take-or-pay commitments made over the last five to ten years may operate to limit new drilling activity by producers. This is possible because certain interstate pipelines, which still need long-term supplies, have dramatically reduced their gas purchasing activity solely because they cannot cope with the supplies they have in the short-term. Even if a producer offered to sell new gas to them at a lower price, these pipelines would not be in a position to buy it because, even at a lower price, the new supplies would only compound the buyer's take-or-pay problems. Similarly, when forced by markets to reduce takes from producers, pipelines will often attempt to minimize take-or-pay penalties by cutting back purchases under old, low cost gas contracts, which tend to have lower take-or-pay requirements. In this sense, the NGPA may be operating to establish a special "vintage" of extremely high gas prices which will adversely affect both deliveries of old gas and exploration and development of new gas.

Despite all of these problems, take-or-pay clauses are not inherently bad, at least in principle. Natural gas producers face relatively high risks and costs in the search for new supplies, and their markets may be limited to buyers who have or are willing to install pipeline facilities. Consequently, it is not surprising that gas producers need some contractual protection of cash flow to assure both adequate compensation for supplies under contract and adequate funds to facilitate the search for new supplies. In a functioning free market, therefore, one would expect contracts between producers and purchasers to contain take-or-pay or comparable clauses (e.g., contracts specifying a schedule of deliveries over the life of the well) to provide producers some cash flow protection without totally insulating them from all market risks which may result from rising prices. However, in a free market, one would also expect buyers and sellers to negotiate take-or-pay terms in conjunction with pricing clauses. For example, a buyer might be willing to pay a higher price to receive the flexibility associated with a lower take-or-pay obligation. Correspondingly, a producer might be willing to accept a lower unit price in exchange for the buyer's higher take-or-pay commitment.

Unfortunately, to date, pipelines have shown little or no sensitivity to the relationships between price and take-or-pay. Over and over again, they have committed themselves simultaneously to indefinitely escalating prices and extreme, fixed take-or-pay clauses. The resulting mess is one of their own making, and the customers of those pipelines should not be subjected to the added costs which would result from take-or-pay expenses and the corresponding declining sales.

2. Proposed FERC Actions

The Industrial Groups urge the Commission to take steps designed to protect customers from extreme take-or-pay clauses. The goal should be to encourage the development of gas purchase contracts which provide either (a) that the purchaser's take-or-pay obligations decline from a maximum of 85%-90% as the prices paid for natural gas increase above a Commission-approved level (*e.g.*, a Section 102 price or the average wellhead price expected to prevail in a free market), or (b) that the purchaser's take-or-pay commitment not exceed a fixed percentage approved by the Commission (*e.g.*, 75% of annual volumes tendered by the producer).

Direct precedent for the use of a sliding scale take-or-pay level exists in the Commission's orders in the Canadian pre-build gas import proceedings. */ In that case, the Commission ruled that the U.S. purchasers' annual take-or-pay obligation would have to be limited to a total dollar amount, adjusted for inflation. Under the arrangement, the minimum volume to be purchased declines in direct proportion to any increase in price, so that the product of the two yields the same dollar total, adjusted for inflation.

The sliding scale approach may have the practical advantage of giving the producer somewhat greater cash flow

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*/ See Northwest Alaskan Pipeline Company, Docket Nos. CP78-123, *et al.*, Order of April 28, 1980 (pp. 55-64), Order of June 13, 1980 (pp. 8-12), Order of June 20, 1980 (pp. 2-10).

protection than the fixed percentage approach, although it still has the problem of insulating the producer's annual cash flow from market forces even if he raises prices in the face of falling demand. Ideally, the producer should not be totally insulated from declining cash flow if he raises his prices in the face of falling markets; so some further adjustment may be appropriate. */

Two methods for implementing these options should be considered.

> First, the Commission could adopt a rule applicable to pipelines' rates which creates a strong presumption that take-or-pay expenditures will neither be currently recovered nor included in a pipeline's rate base unless the relevant gas contracts satisfy the criteria set forth above. **/
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> Second, the Commission could adopt a rule which makes all new certificates of public

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*/ For example, it may be appropriate to have the maximum volume obligation decline more rapidly than the rate of price increases. This would assure that the producer recognized market risks inherent in increasing prices.

**/ The Industrial Groups suggest that this be established, by rule, as a strong factual presumption (as opposed to a mere procedural device for shifting the burden of proof), recognizing that there may be limited instances in which the incurrence of take-or-pay costs is, in fact, in the best interest of the pipelines' customers. For example, it is conceivable that in certain instances a small take-or-pay cost would be cheaper than storage alternatives which would otherwise be beneficial to the pipeline's customers.

convenience and necessity for the transportation or resale of natural gas and all blanket certificates under 18 C.F.R. §157.201-218, */ subject to the condition that the underlying gas is purchased under contracts which meet the above criteria.

It is clear that the Commission has the legal authority to address the take-or-pay problem in either of the ways suggested. While Section 601(c) of the NGPA establishes the standards for reviewing prices paid by interstate pipelines for natural gas to be resold to their customers, it does not require that pipelines be permitted to recover payments for unneeded gas which, in fact, is neither currently purchased nor resold.

Thus, with respect to pipelines' rates, nothing in Section 601 requires the Commission currently to pass through prepayments for supplies that will only be taken and resold in the future (or possibly never). Nor is there anything in the NGPA which requires that the Commission treat imprudent take-or-pay prepayments as working capital on which the pipeline's rate

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*/ See also 18 C.F.R. §284.221-222. In Section 157.206(a)(1), the Commission reserved the right to modify standard conditions imposed on blanket certificates. To the extent budget certificates survive implementation of the blanket certificate rule, it would also be desirable to impose these conditions on budget-type certificates. See generally 18 C.F.R. §157.7.

of return is earned. */ The Commission's current practice of treating take-or-pay expenditures as working capital to be included in pipelines' rate bases remains an issue solely for consideration under Natural Gas Act standards.

Of course, in implementing such a rule in individual cases, the Commission would have to presume that take-or-pay costs are always incurred on the most expensive supplies, absent an operational inability to take cheaper supplies first. Thus, the amount subtracted from working capital would have to equal the volume of gas on which prepayments have been multiplied by the highest prices paid for gas by the pipeline. This could lawfully be done under the NGA's "prudence" standard and the NGPA's "fraud, abuse or similar grounds" standard. It would certainly be improper and an abuse of a pipeline's discretion and legal duties for a pipeline to shift its imprudent take-or-pay expenses to its customers by incurring take-or-pay on its cheapest gas sources while purchasing full volumes of its high-

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*/ The potential impact of treating take-or-pay costs as working capital can be substantial. For example, in Docket No. RP82-55-000, Transco indicated that it faces potential take-or-pay expenses for up to $450 million and has asked for a rate of return of 14.52%. If Transco were to get both in its rates, the annual charges to its customers would be increased by millions of dollars.

est cost supplies. Given two supplies under contract, the pipeline still has a duty to purchase the cheapest supply first. [*]

As another approach to take-or-pay problems, the Commission could also promulgate a rule conditioning new certificates and blanket certificates issued under Section 7 of the NGA, to prohibit transportation or resale of natural gas in interstate commerce unless such gas was purchased under contracts meeting the take-or-pay criteria set for the above. The Commission's broad authority to place conditions on certificates is well established under the Natural Gas Act, [**] and the limitation set forth in NGPA Section 601(c)(1) is not applicable here.

NGPA Section 601(c)(1) prohibits the Commission from denying or conditioning a certificate on the basis of the price paid in a first sale if the prices are deemed "just and reasonable" by Section 601(b). That provision does not, however, limit the Commission's authority to deny or condition certificates on the basis of volumetric and other non-price considerations, such as take-or-pay clauses. */ Furthermore, since prepayments under take-or-pay clauses do not constitute actual "sales" of natural gas, Section 601(c)'s limitations on the Commission's authority are inapplicable. **/ Thus, with respect to take-or-pay clauses, the Commission remains free to impose reasonable certificate conditions required by the public convenience and necessity.

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[*] Obviously, confronted with the risk of bearing the cost of imprudent take-or-pay expenditures, interstate pipelines would have a strong inclination to avoid such costs by purchasing the most expensive supplies first and their least expensive supplies last. Such a pattern would, of course, stand on its head the kind of rational market behavior which Congress hoped would result when it voted to move toward gas price deregulation. Congress certainly did not intend that pipelines purchase high cost supplies preferentially over otherwise identical low cost supplies. For this reason, the Commission should establish a strong presumption that take-or-pay costs are attributable to the most expensive sources of supply then being purchased by the pipeline, unless it could be shown that the most expensive source could not be physically cut back further.

[**] See, e.g., Atlantic Refining Co. v. Public Service Commission of New York, 360 U.S. 378 (1959).

B. Application of the Fraud, Abuse, or Similar Grounds Standard.

The Industrial Groups disagree strongly with the Commission's present views concerning the proper application of NGPA Section 601(c)(2)'s "fraud, abuse or similar grounds" standard. ***/ In its Statement of Policy and other orders, the Com-

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*/ Since passage of the NGPA, for example, the Commission has continued to enforce its requirement that take-or-pay clauses provide five-year make-up provisions. See 18 C.F.R. §154.103; Exxon Corporation, Docket Nos. CI78-758 et al., Order of May 28, 1981.

**/ A prepayment under a take-or-pay clause is not a "sale of any volume of natural gas" for purposes of the NGPA. First, there is obviously no present transfer of natural gas. Second, gas volumes on which prepayments are made may never be transferred from the seller to the buyer. Third, the price is generally not finally determined at the time of the prepayment, and an additional payment may be required, at such time as the gas is taken, to reflect higher prices then chargeable under the contract. Lacking a final "sale," the restrictions described in Section 601(c) simply do not apply.

***/ Compare the Commission's Statement of Policy concerning Fraud standard, Docket No. PL82-1-000, issued February 4, 1982,

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mission has taken the position that the NGPA's "fraud, abuse or similar grounds" standard prescribes the narrowest possible scope of review, limiting the agency's review of a pipeline's gas purchase costs to instances in which fraud or fraud-like behavior can be proven. Absent proof of material misrepresentations of fact, the Commission has indicated that it will take no steps to protect consumers. The Industrial Groups, on the other hand, have indicated their belief that Congress intended the Commission to exclude excessive gas costs to the extent that they are caused by abuses of management discretion, abuses of the pipeline's duty to its customers (e.g., its duty to take all reasonable steps to provide adequate service at the lowest resonable rates), or abuses of the regulatory program embodied in the NGPA.

The Industrial Groups have expressed these views in great detail in their Application for Rehearing of the Commission's February 4, 1982 Policy Statement, in Docket No. PL82-1-000. */ This Application is incorporated herein by reference.

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with the Application for Rehearing of the Statement of Policy filed by the Process Gas Consumers Group, the American Iron and Steel Institute, the Association of Businesses Advocating Tariff Equity, The Brick People, et al. and the Georgia Industrial Group. See generally Order Granting Rehearing for Purposes of Further Consideration, Docket No. PL82-1-000, issued April 7, 1982.

*/ See also Application for Rehearing of the Process Gas Consumers Group, filed July 30, 1982, in Tennessee Gas Pipeline Company (a Division of Tenneco, Inc.), Docket No. TA82-2-9-000.

The Industrial Groups urge the Commission to reconsider its position. The Commission's interpretation of NGPA Section 601(c)(2) seriously erodes the Commission's ability to enforce interstate pipelines' fundamental duties to their customers, including their duty to take all reasonable steps to provide adequate gas service at the lowest reasonable cost. By adopting an extreme position intended to avoid any consideration of prices agreed to by pipelines and producers, in the name of avoiding "backdoor producer regulation," the Commission abdicates its duty to regulate interstate pipelines. The Commission's course is inconsistent with the law and represents an abuse of its discretion. A balanced application of the "fraud, abuse or similar grounds" standard can avoid either the extreme of indirect regulation of producers or the extreme of inadequate regulation of interstate pipelines.

The Industrial Groups urge the Commission to adopt certain rebuttable presumptions to govern interstate pipelines' PGA rate cases, as well as to examine purchasing practices closely in individual PGA cases. Specifically, these presumptions should, at a minimum, make it clear that the pipelines will have to bear an affirmative burden of proof to show that their gas costs are not "excessive due to fraud, abuse or similar grounds" in the following instances:

(a) in any case in which an interstate pipeline has failed to exercise market-out clauses or similar renegotiation clauses in existing contracts, notwithstanding the adverse effects high prices are having on the pipeline's ability to resell gas;

(b) in any case in which an interstate pipeline has failed to include market-out or similar renegotiation clauses in contracts for deregulated gas, especially contracts containing definite or indefinite pricing clauses which will predictably take the price of gas above the level which would be expected to prevail in a free market environment; and

(c) in cases in which prices for new gas exceed the range of prices which would be expected to prevail in a truly free market.

The Industrial Groups submit that the foregoing presumptions would be both lawful and reasonable. Interstate pipelines always bear the burden of proof with respect to proposed rate increases. This burden is well established in the Commission's regulation of interstate pipelines under the Natural Gas Act, and nothing in the Natural Gas Policy Act of 1978 altered that burden. The basis for that burden is found both in the Natural Gas Act's requirement that pipelines demonstrate the lawfulness of any proposed rate increases and by the practical consideration that interstate pipelines are in possession of virtually all the data needed to determine whether their gas purchasing decisions are permissible ones. */ In this regard,

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*/ For example, pipelines possess the relevant gas purchase contracts; they are familiar with the circumstances surrounding the negotiation of each of those contracts; they are most familiar with the data from which one can determine whether

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the burden of proof concerning "fraud, abuse or similar grounds" issues should be treated like the burden of proof on "prudence" issues, as to which it has been held:

> "Utilities seeking a rate increase are not required to demonstrate in their cases-in-chief that all expenditures were prudent .... However, where some other participant in the proceeding creates a serious doubt as to the prudence of an expenditure, then the applicant has the burden of dispelling these doubts and proving the questioned expenditure to have been prudent." */

The Industrial Groups submit that the existence of any the circumstances outlined above is sufficient to create "serious doubt" as to whether a pipeline has committed an "abuse" or a "similar" violation of its duties to its customers. For example, given current and projected declines in sales volumes due in lart part to growing conservation and fuel switching, it is extremely difficult to see how a pipeline could reasonably justify a decision to continue paying extreme gas prices when it has existing contractual authority to lower the price. Consequently, to the extent an interstate pipeline has contractual rights to reduce the price it is paying to producers, the Commission can reasonably presume the existence an

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there was a genuine market need for the gas that has been purchased; they are familiar with the gas purchasing competition during the relevant period; they know their overall gas purchasing policies and strategies; etc.

*/ See City of Anaheim, et al. v. FERC, 669 F.2d 799, 809 (D.C. Cir. 1981), citing Opinion No. 86, Minnesota Power & Light Co., FERC Docket No. ER76-827 (June 24, 1980).

abuse of management discretion on the part of any pipeline which fails to exercise its market-out clauses in the face of declining sales. */

It is also difficult to imagine satisfactory reasons for pipeline's failures to include effective market-out clauses in contracts for high cost deregulated gas. Given the long-standing recognition of the need for market-out clauses and the well-documented danger to gas markets from extreme price and take-or-pay provisions, it would be an inexcusable abuse of discretion for any pipeline to sign contracts locking it into higher and higher prices, without obtaining a reasonable market-out clause for its customers' protection. This observation, which is clearly supported by recent experience, provides a reasonable basis for establishing a second evidentiary presumption in PGA cases.

As to the third suggested presumption, the Industrial Groups recognize that there may be special circumstances in which agreements to pay prices above the expected market level might be reasonable. For example, it might be reasonable to pay a premium to obtain relatively short-term supplies needed

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*/ It would certainly not constitute "backdoor producer regulation" for the FERC to block the passthrough of gas costs which are in excess of the minimum price required by contract. That is, given the existence of freely negotiated contractual terms permitting the pipeline to pay a lower price for the gas, Commission intervention to block passthrough of costs above the contractual minimum would only involve review of the pipeline's discretion, without in any way involving so-called backdoor regulation of the contractual terms that producers seek to include in the contracts.

to forestall imminent supply shortages. Similarly, it might be reasonable to pay a premium in exchange for unusually favorable take-or-pay terms. Thus, the pipeline may have an easier time meeting its burden of proof with respect to the third suggested presumption, particularly where the gap between the price paid and the market price is small. Nevertheless, this presumption would be important at least in establishing the initial burden of justification.

In sum, the Commission has authority to establish reasonable rebuttable presumptions, such as those outlined above, which will make the pipelines' burden of proof clear in most PGA proceedings and at least establish a presumption as to how pipelines should behave during the transition to deregulation.

C. Rate Mechanisms to Provide Economic Incentives for Sound Gas Purchasing Practices

For the interstate gas system to function efficiently and reliably, both during and after the transition to deregulation, the Commission must develop sound rate mechanisms to assure that pipelines have adequate incentives to keep deregulated gas costs within reasonable bounds while providing full service to their customers. This is particularly true given the Commission's narrow view of its authority to review directly the reasonableness of gas costs under the NGPA.

Unfortunately, the Commission's current ratemaking policies do not help to achieve these goals. Instead, a pipeline's ability to recover its costs and to earn a full return on its investment is now determined with little or no regard to whether pipeline management has fulfilled its duties to minimize gas costs. And, pipelines are free to seek ever higher unit rates to reflect declining sales even if the dropping sales are attributable to the pipeline's imprudent incurrence of extreme gas purchase costs. */

Although the Commission's Notice of Inquiry suggests that incentive rate of return concepts should be developed in individual proceedings, the Industrial Groups suggest here some of the options which the Commission and parties before it should be considering in this regard. Moreover, while some adaptations might be needed for individual pipelines, there is no reason why the basic terms of an incentive rate policy cannot be set forth by either a rule or a policy statement. **/

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*/ The imprudence of paying gas costs in excess of estimated market clearing levels is established, for example, by the Commission's Order in Transcontinental Gas Pipe Line Corporation, Docket No. CP81-274-000 (May 4, 1982).

**/ There is no doubt about the Commission's legal authority to develop an incentive rate of return mechanism designed to focus pipelines' attention on the reasonableness of their purchasing practices. Even assuming the NGPA required liberal passthrough of gas purchase costs, nothing in that Act evinces a broad intent to replace the Natural Gas Act's consumer protection objectives with an unquestioning, cost-plus ratemaking scheme. Two of the basic premises of utility law -- (1) that no utility is guaranteed a fair return on investments, only an opportunity to earn one, and (2) that utilities have a duty to exercise their managerial skill to provide adequate service at the lowest reasonable cost -- remain as valid today as before the NGPA was passed. Further, as previously noted, while Section 601(c) limits the Commission's ability to deny or condition certificates of public convenience and necessity or to deny passthrough gas costs on the basis of first sale prices which are deemed just and reasonable under Section 601(b), nothing in the Act limits the Commission's authority to condition rates of return or pipelines' ability to recover other costs (e.g., working capital costs associated with high cost Section 107 purchases or with take-or-pay expenditures).

In devising an incentive rate of return, two fundamental goals must be kept in mind. First, pipelines should be given an unambiguous economic incentive to provide full service to their customers by requiring them to share the adverse economic consequences of any gas curtailments. */ Second, a pipeline's opportunity to earn a full return on its investment should be conditioned upon its providing service at the lowest reasonable cost, which includes keeping its gas purchase costs at the lowest level reasonably possible.

A variety of possible approaches could be employed in developing rate incentives designed to achieve the foregoing goals. Moreover, a number of other interested parties are currently working on the problem of developing a balanced set of incentives. **/ Thus, the Industrial Groups' two suggestions are preliminary and should be considered along with other possibilities.

1. An Incentive Sales Level

As one possible incentive to keep gas supplies marketable, the Commission could calculate unit rates on the basis of its best estimates of the sales level which would be achieved if the pipeline provided full service without incurring gas purchase costs above a level specified by the Commission. Under such an "incentive sales level" approach, the Commission would estimate the volume of sales which would occur, for example, if the pipeline met all of its customers' requirements without its average gas costs exceeding the price level expected to prevail in a functioning free market. With rates so calculated, any decline in sales -- whether attributable to curtailments or to unreasonable gas purchase costs -- would result in lost profits for the pipeline. */ Such a result would be similar to the type of profit reduction which competitive companies and their stockholders would expect if the companies incurred unreasonable operating costs.

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*/ Reduced gas sales may somewhat limit pipelines' long-term prospects for growth; yet, under current Commission rate policy, declining sales (whether caused by curtailments or imprudent gas purchases) may have only a limited impact on a pipeline's profitability. This may be particularly true when the pipeline, through an affiliate, has targeted exploration and development as its basis for future growth rather than more traditional pipeline enterprises.

**/ For example, testimony recently presented by Peoples Gas Light & Coke and by NGPL, in Natural Gas Pipeline Company of America, Docket No. RP81-49, propose two possible rate structures, each of which is ostensibly designed to give pipelines fair, market-oriented incentives.

While an incentive sales level would provide an incentive for keeping down gas costs to a reasonable level, there would necessarily be some difficulty in estimating the level of sales which would likely occur if the pipeline pursued reasonable gas purchasing policies. However, given the fact that routine estimates of sales levels, which are contained in pipe-

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*/ In the event of gas curtailments, it would also be appropriate to make demand charge adjustments to reflect the pipeline's failure to satisfy contract demand. Pipelines should not perceive mandatory curtailments and customers' decisions not to buy gas as functionally equivalent from a rate standpoint. Thus, combining such a demand charge adjustment with the incentive sales level would have a further beneficial effect of penalizing pipelines more for causing gas curtailments than for paying a premium for new gas. This is as it should be since the pipelines should have as their primary goal the fulfillment of their customer demands.

lines' test period adjustments, already account for potential conservation and fuel switching in most cases, the Commission and the parties before it have some experience in this area. In any event, a reasonable estimate should be possible even if perfection is not.

An incentive sales level scheme might be a particularly effective method for giving pipelines an incentive to deal with the contract problem before 1985. This could be accomplished, for example, by freezing the sales volumes used in calculating rates applicable during 1985 at the level of actual sales during 1984.

2. Sliding Rate of Return

The Commission should also consider adopting a sliding rate of return on equity which would reward pipelines for maintaining full service at low gas costs (relative to a predetermined measure) while penalizing curtailments and/or unduly high gas costs. */ The essential contours of an incentive rate of return scheme can be defined generically, even though implementation would require some case-specific data.

Initially, the Commission would have to define the range over which the rate of return could vary depending upon the pipeline's gas purchasing practices. One obvious possibility would be to employ the "range of reasonableness" within

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*/ Development of a sliding scale rate of return was recently ordered by the Commission in Virginia Electric and Power Co., Docket Nos. ER81-388 et al., June 28, 1982.

which the Commission would ordinarily establish a pipeline's rate of return. Once the range is established, the scale for rewarding or penalizing departures from the mean would need to be established. Such a scale should reward full service at low gas costs, while penalizing curtailments and unduly high gas costs. In the case of curtailments, demand charge adjustments would also be appropriate. */

The key to such an approach would be identifying the proper point of reference for measuring reasonable gas costs, which would enable a pipeline to receive a rate of return which falls in the middle of the range of reasonableness. This could be done in any of several ways, each of which would be susceptible to a generic determination by the Commission.

For example, the Commission could compare the average cost of the individual pipeline's purchases of "new gas" to the average cost of all interstate pipelines' "new gas" purchases. Then, to the extent an individual pipeline is able to provide full service to its customers while keeping its average cost of new gas below the national average, it would receive a proportionally higher rate of return on its investment. On the other hand, to the extent the individual pipeline either (1) fails to provide adequate service or (2) pays an average cost for new gas which exceeded the average of all pipelines' cost of new gas, it would receive a relatively lower rate of return. The average cost of new gas purchases against which each pipeline's

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*/ See footnote, page 79, *supra*.

rate of return would be measured could be published by the Commission on a periodic basis, so that it would not have to be recalculated in every rate case.

Using average new gas costs as the benchmark would be beneficial because it would reflect the dynamics of the marketplace, and it would give pipelines an incentive to compete to keep their gas costs at the lowest possible level. Such competition would parallel the competition seen in competitive markets by manufacturers whose profit margins and sales are largely determined by their ability to hold down their costs. Using the average cost of new gas would also dilute any special advantages afforded to some companies by their relative shares of the old gas cushion. Because of the beneficial effects of encouraging competition between interstate pipelines to keep costs low, there might be an advantage to adopting a generic requirement even if the application and implementation of such standards would require some case-by-case adjustments. */

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*/ Other obvious alternative measures for implementing an incentive rate of return include (1) comparison of an individual pipeline's deregulated gas purchase costs against either prices that the Commission would expect to prevail in a free market or the average price paid by all pipelines for deregulated gas; (2) comparison of a pipeline's average gas costs against the average gas costs of all pipelines; and (3) comparison of pipelines' average gas costs under contracts signed after a date fixed by the Commission. Obviously, the design of the measure would significantly influence the force of the incentive; and, in each case, some provision will be necessary to assure that curtailments are not seen by the pipeline as an option for avoiding a rate of return reduction. It is important, above all, to assure that consumers have a choice of whether to purchase the pipeline's gas, and a pipeline should not be permitted to keep its average gas costs down by curtailing service its customers.

Finally, the ideas of incentive sales levels and incentive rates of return are not necessarily mutually exclusive. It may, in fact, be reasonable to employ both devices to assure that particular pipelines have adequate incentives to assure vigorous interpipeline competition to minimize gas purchase costs.

The Industrial Groups encourage the Commission to pursue this incentive issue both generically as well as in individual cases. Effective devices for promoting pipeline management efficiency must be developed at the earliest possible stage to assure sound gas purchasing behavior as we move into a deregulated environment for new gas supplies.

D. The Commission Should Require The Public Filing Of All New Gas Purchase Contracts.

To aid the Commission, Congress, and the public in assessing natural gas market conditions and pricing practices under the NGPA, the Commission should fully utilize its authority under Section 315 of the NGPA to gather, review, and make public new contracts to purchase gas at the wellhead for eventual resale to the public. The Commission should promulgate a rule requiring all first sale purchasers of natural gas for resale, including all successors to existing contracts or rollover contracts, to file their gas purchase contracts with the Commission, together with any ancillary agreements. All contracts should be filed at the FERC on a pipeline-by-pipeline basis and should be available for public inspection. The contracts should also be indexed according to sections of the NGPA applicable to the underlying gas (e.g., Section 102, 107). At a minimum, meaningful summaries of the principal pricing and quantity terms in each contract (including market-out and take-or-pay clauses) should be made available to the public on a pipeline-by-pipeline basis.

By fully exercising its authority under Section 315(c), the Commission will greatly enhance its ability to monitor pricing developments and, where necessary, to develop new guidelines to protect the public interest from abusive and imprudent pipeline purchasing practices. In addition, making these contracts public would enhance public and Congressional awareness of the nature of new gas contracts and thereby increase the likelihood that rational and timely steps, including any appropriate amendments to the NGPA, will be taken to mitigate future price and supply disruptions. Furthermore, because pipelines have a monopoly position which leaves customers with little recourse against pipelines' unreasonable gas purchasing practices, it is important that customers at least be given sufficient information on pipeline purchasing practices to enable them to anticipate rate increases and consumer responses. Increased public and customer awareness will also exert pressure on pipelines to adopt balanced purchasing practices. Finally, by treating all pipeline purchases equally on this issue, none will be able to complain of having suffered any competitive disadvantage in dealing with producers.

VI. PROPOSALS TO ELIMINATE ROLLED-IN PRICING SHOULD BE REJECTED.

In its description of allegations of current gas market problems, the Notice of Inquiry notes the allegations made by the People of the State of California and the Public Utilities Commission of the State of California ("California") and by Laclede Gas Company ("Laclede") that the combination of NGPA Section 107 and the Commission's traditional allowance of rolled-in pricing "unduly subsidizes the production of deregulated gas to the detriment of the ultimate users." (NOI, at 14-15). These allegations apparently led the Commission to include the following among the Questions and Issues set forth in NOI Appendix B: "To what extent would market ordering problems be mitigated if [the] averaging process were prohibited? Are there any policy reasons for retaining this averaging process?"

In response, the Industrial Groups respectfully submit that there are substantial policy reasons why the averaging process should be maintained and other means be utilized to address the Section 107 problem.

A. California's and Laclede's Allegations

In its April 28, 1981 Petition for a Generic Rulemaking Proceeding (Docket No. RM81-30), California queried "whether the purchase of deregulated gas at prevailing prices is in the public interest and, if not, whether an appropriate regulatory mechanism can be instituted to restrain the prices to a level where the purchase of deregulated gas would be in the public interest." (Calif. Ptn. at 1). In response to California's questions, and as described in detail elsewhere in these comments, the Industrial Groups believe that, by and large, the prices which pipelines are paying for deregulated Section 107 gas are excessive, abusive, and inconsistent with the public interest. However, the regulatory mechanism which California suggests be instituted to restrain Section 107 prices would be, at best, fraught with problems and, at worst, unduly discriminatory and violative of both sound economic and public utility policy.

While California appears to recognize that artificially high Section 107 prices are due in part to "the very limited grounds available to question the flow through of gas prices in Purchase Gas Adjustment (PGA) proceedings" (Calif. Ptn. at 3), it places substantially more emphasis in its petition on "the inability of distribution companies to reject specific [high-cost] supplies of gas." (Id.) California asserts that the absence of a mechanism to allow such rejection "allows for the maintenance of artificial prices not subject to market forces." (Id. at 5).

Like California, Laclede also complains that rolled-in pricing is "frustrating the ability of the marketplace to realistically balance and reject inordinately high deregulated wellhead prices." */ However, in contrast with California's rather general proposal for some mechanism to allow distributors to reject high-cost supply increments, Laclede offers specific proposals designed to reduce overall gas demand by delivering a one-two punch to so-called "low priority" gas uses. Laclede proposes (1) to price boiler fuel users out of the gas market through an adulterated form of "marginal cost pricing" which allocates all deregulated gas costs only to such users, and (if this is not sufficient to knock out boiler fuel use), (2) to have the Commission institute abandonment proceedings for "certain large scale marginal boiler fuel sales." (Laclede Ptn. at 12).

The Industrial Groups strongly urge the Commission to reject both California's and Laclede's ill-considered proposals.

B. The Premises Underlying the California and Laclede Proposals are Seriously Flawed.

The Industrial Groups concede that rolled-in pricing is one of a number of factors which, taken in combination, currently allow some pipelines to pay excessive prices for deregulated gas supplies. However, the Industrial Groups strongly disagree with the notion that elimination of rolled-in pricing would be either (1) a sound method for dealing with market or-

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*/ Laclede Gas Co., Petition For Rulemaking To Establish Revised Policies Under The Natural Gas Act Respecting The Purchase and Use of Gas, Docket No. RM82-1 (Oct. 2, 1981), at 11.

dering problems, or (2) consistent with Congress' intent in the NGPA. Both California's and Laclede's proposals rest on several fallacious premises. Because these premises are so essential to those parties' proposals, the following sections are devoted to demonstrating the invalidity of these premises and the inappropriateness of relying on them in the formulation of natural gas policy.

1. California asserts that "the current market situation supported indirectly by the FERC through the mechanism of rolled-in pricing and typical pipeline tariffs and PGA provisions circumvents the will of Congress that certain deregulated gas supplies face the test of market forces while other supplies remain regulated." (Calif. Ptn. at 4) (emphasis added). However, this statement -- upon which California's proposal is largely premised -- is seriously misleading as best.

To be sure, Congress did intend that "certain deregulated gas supplies face the test of market forces;" NGPA Section 121(b) removes ceiling prices from gas described in Sections 107(c)(1), (2), (3), and (4), allowing such gas to be sold at whatever price it might command in the NGPA's part-regulated/part-deregulated market. It is true that, although this transitional hybrid nature of the NGPA-created market necessarily precluded its being a fully free market, Section 121(b) was intended to leave Section 107 gas free from price constraints. It is simply wrong, however, to assert -- as California implicitly does -- that Section 107 gas was also intended to face the test of full free market demand forces. Congress knew well that, just as there can be no free market on the supply-side as long as a portion of the market remains subject to wellhead price controls, there can likewise be no free market on the demand-side until that regulated gas "cushion" has been exhausted.

The so-called incremental pricing program established by Title II of the NGPA was the means through which Congress intended to bring some end-users' gas rates closer to free-market levels (i.e., the prices of alternate fuels) and thus, it was hoped, restrain pipeline bidding for high-cost supplies. However, as the Conference Report on the NGPA explained, "Only certain portions of an interstate pipeline's acquisition cost of natural gas are subject to the incremental pricing requirements and are required to be placed in the incremental pricing account for pass-through to low priority users under sec. 203." */ That is, Section 203 provides which gas acquisition costs shall be subject to incremental pricing and which shall not be. Most incentive gas is incrementally priced as to that portion of its cost which exceeds the "incremental pricing threshold" defined in Section 203(c) -- a threshold which has climbed with inflation from $1.702 in January 1980 to $2.129 in August 1982. Thus, for example, a pipeline purchasing Section 102 gas at its

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*/ Joint Explanatory Statement of the Committee on Conference, S. Rep. 95-1126, 95th Cong., 2d Sess., at 95.

August ceiling price of $3.176 would be required to include approximately $1.05 of that price in its incremental pricing account to be charged first (to the extent possible) to industrial boiler fuel users. In significant contrast, however, Section 203(a)(7) provides that in the case of all high-cost gas (both deregulated and regulated), incremental pricing shall not come into play until the cost of such gas exceeds 130 percent of the price of No. 2 fuel oil. This special incremental threshold for high-cost gas has been in the range between $7.11 and $9.51 since the Title II program began in January 1980. Thus, for example, a pipeline purchasing Section 107 gas this month for anything up to $8.67 is not required to incrementally price any portion of that cost.

This analysis of NGPA Section 203 supports the view that Congress itself intended that Section 107 gas be rolled in with other system supplies to an even greater extent than gas in other incentive categories (*e.g.*, Sections 102 and 103). */ Thus, far from circumventing the will of Congress, as California claims, the application of rolled-in pricing to virtually all Section 107 gas costs was in fact mandated by Congress in the NGPA. Congress gave the FERC no discretion to expand the pool of gas costs subject to incremental pricing, and any effort by the Commission to incrementally price all high-cost gas (such as through required separate contracting or similar schemes) would itself circumvent the will of Congress.

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*/ In August 1982, there is more than a $6.50 difference between the regular incremental pricing threshold and the special threshold applicable to high-cost gas only. This difference represents the extra roll-in capacity which Congress intended to accord high-cost gas before incremental pricing would begin to apply.

2. Laclede's proposals are more specific and varied than California's, but they too are grounded on invalid premises:

(a) In urging the elimination of rolled-in pricing for sales to "low priority users", Laclede "assumes the priority arrangement prescribed in the Commission's Order No. 467-B." (Laclede Ptn. at 3 n.1). That is, Laclede has borrowed the term "low priority users" from curtailment policy to refer to large volume boiler fuel customers (e.g., electric generating stations). Id.

Unfortunately, there is a fundamental conceptual flaw in Laclede's equating of low priority for purposes of scarce supply allocation with low priority for purposes of cost allocation. When designing interstate pipeline rates, FERC is dealing with concepts which are entirely different from those applicable to the establishment of curtailment priorities. To be sure, the rules in the two areas must be made consistent with each other and must be designed to further a cohesive policy, but the relationship between the two types of decisions is far more complex than the appealingly simplistic relationship which Laclede suggests.

In determining a policy for natural gas curtailments, the Department of Energy and the Commission are deciding administratively which consumers should be preferred in terms of continuity of service when the supply of gas is inadequate to meet the demands of all consumers. This problem has been resolved properly, if imperfectly, by the design of a curtailment policy based in part upon the end use to which the gas is put, with the uses which can most economically be converted to alternate fuels classified in the lower priorities and the uses for which conversion to alternate fuels is the most expensive (where such conversion is possible at all) classified in the highest priorities. The Industrial Groups strongly support this end-use/cost of conversion approach to curtailments.

However, in attempting to design pipeline rates and to determine how new increments of gas supplies should be priced, the Commission is dealing with an entirely different type of administrative decision. In this case, the decision before the FERC is not who will get scarce supplies when demand exceeds supply, but rather what rates various classes of consumers will be required to pay for the supplies which are available. Factors relevant to that decision include proper functionalization, classification, and allocation of pipeline costs, proper assignment of cost responsibility among jurisdictional customer classes, stability of pipeline revenues, proper projection of sales volumes to permit the company to earn its authorized return, and the like.

Thus, Laclede's plan to attribute the full cost of deregulated gas supplies to "low priority" consumers is no more than an artificial allocation of cost based on inappropriately borrowed curtailment policy factors which are entirely different from those factors which are relevant to a rate design decision. */

(b) Laclede advocates the direct allocation of high-priced gas to "low priority" users because, it argues, such users would not be served if such gas were not purchased. (Laclede Ptn. at 4). Laclede has here raised an argument which surfaces from time to time and is thoroughly discredited each time it is raised -- that the beneficiaries of a given increment of gas

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*/ Indeed, to the extent that existing curtailment policy is useful in making rate decisions, that policy suggests that the rates for the higher curtailment priority users should be higher than the rates for the lower curtailment priority users because of the higher value of the product (including the value of greater reliability of service) being received by those consumers. However, the Industrial Groups do not believe it any more appropriate to borrow this reasoning from curtailment policy than it would be to borrow the concepts advocated by Laclede.

supply (e.g., high-cost gas, imported LNG, or the like) are only those customers who, but for such increment, would not be served. Thus, the argument goes, if certain customers would not be served absent the addition of the supply increment, those particular customers should bear most or all of the costs of that increment. This argument may appropriately be labeled the "beneficiary fallacy".

The Commission has periodically exposed the beneficiary fallacy and rejected it as a basis for establishing special cost allocation schemes. For example, in Opinion No. 796-A, Trunkline LNG Company, Docket Nos. CP74-138, et al., 58 F.P.C. 2935 (June 30, 1977), the Commission flatly rejected an argument quite similar to Laclede's argument here, correctly recognizing that when new gas supplies are intended to constitute a portion of a system's base load, all customers benefit, whether or not they would currently be served in the absence of that supply:

> "One of the primary factors leading us to this conclusion [to certificate the LNG import project with rolled-in pricing] is that this gas should be made available on the Trunkline Gas system as insurance to protect Priority 1 loads and Priority 2 plant protection requirements. . . . As the Commission stated in Columbia LNG, Opinion No. 786 where the gas will be used as base load to serve high priority users in Priorities 1 and 2, rather than as an 'exotic' supplemental supply for use by lower priority users, rolled-in pricing should be used. Thus, with rolled-in pricing, the LNG will be available on the Trunkline Gas system as a part of Trunkline Gas'

> general system supply. Thus, it is only proper that all customers pay their proportionate share of the costs of the LNG since all customers would benefit therefrom." Opinion No. 796-A, supra, at 2940-41 (footnote omitted) (emphasis added).

All of a pipeline's gas customers receive an immediate benefit from the addition of a new supply source. Even if a particular customer or class of customers does not receive additional supplies immediately as a direct result of purchases of deregulated gas supplies, it does receive an immediate benefit as to which there is a real economic value, since the availability of the new supply in the future decreases the risk of curtailment for all customers. In addition, the increased supply and throughput results in an immediate decrease in the portion of the pipeline's capacity costs which must be borne by all customers, so that all customers receive an immediate and direct rate benefit as a result of the greater utilization of pipeline capacity:

> "In the instant case, this supplemental supply will be an integral part of the baseload supply for these pipelines' high-priority customers. By allowing these pipelines to roll-in the LNG for pricing and allocation purposes, customers are afforded the greatest reliability of service. Moreover, under rolled-in pricing the higher priority customers will have a greater assurance of continued supply than the lower priority customers due to the curtailment plans of these systems. In emergency periods during the early years of this project and regularly during the later years, the high priority customers will benefit

> from the regular supply. In the intervening years, the lower priority customers may receive gas at a lower price than its incremental cost; however, ultimately the higher priority customers will receive the full benefit of the supply. *The availability of the supply for their immediate potential use is a form of an insurance policy and has both a social and economic benefit.* We therefore find that it is *appropriate that these consumers should bear part of this cost*." Opinion No. 786, *Columbia LNG Corporation*, Docket Nos. CP71-68, *et al.*, 57 F.P.C. 354 (Jan. 21, 1977), at 365-6 (emphasis added).

Anticipating Laclede's potential response to the foregoing argument, the Industrial Groups would strongly disagree with any claim that the recent *United* decision with respect to emergency gas purchase costs [*] supports abandonment of the Commission's historic preference for rolled-in pricing. The Industrial Groups believe that, even assuming *arguendo* that the *United* case adopted a "beneficiary" rationale (a point which the Groups do not concede), that case would *not* control in the context of deregulated gas purchases. The emergency gas purchases at issue in the *United* case were limited to a term of 60 days and were permitted only when necessary to offset curtailment. In contrast, deregulated gas purchases are not so limited as to term and, of course, may be made whether or not there is a threat of curtailment. *A fortiori*, in these days of short-term gas surplus, Section 107 gas purchases are a supplemental pipeline supply source, not a stop-gap remedy for curtailment. */ Unlike the 60-day emergency purchases which were the subject of the United proceeding, deregulated gas purchases (like other purchases for general system supply) are supposed to serve the needs of all pipeline customers, including "high-priority" users. The United decision, therefore, should not be viewed as precedent for departing from rolled-in cost allocation as the general rule. **/

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[*] *United Gas Pipe Line Co. v. FERC*, 649 F.2d 1110 (5th Cir. 1981), *aff'g. United Gas Pipe Line Co.*, Docket No. RP72-133 (July 18, 1979).

(c) Laclede asserts that the incremental pricing provisions of NGPA Title II were "designed in part to assure that the regulation of market prices to consumers should not result in the retention of price-sensitive marginal users who would cease their purchases if compelled to pay the higher new gas prices prescribed under Title I of the NGPA." (Laclede Ptn. at 7.) Laclede attributes the failure of the incremental pricing program to (1) FERC's ineffectiveness in identifying incremental pricing ceilings, (2) the Congressional veto of Order No. 80, which would have expanded the scope of the program to virtually all industrial users, and (3) NGPA Section 206(c)(2)'s exemption of electric utilities.

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*/ In contrast, the Commission exhorted purchasers under the 60-day program at issue in United to "make every reasonable attempt to conduct their operations in such a manner as to minimize or, if possible, to avoid continuing reliance upon emergency natural gas supplies." 18 C.F.R. §157.48(a)(1).

**/ See also Order Denying Rehearing, Northern Natural Gas Company, Docket No. CP81-349-000 (Feb. 9, 1982), in which the Commission itself distinguished the United decision on its facts, cited Northern's need to acquire new long-term gas supplies, and rejected Laclede's arguments that Northern's one-year sales of surplus gas should be incrementally priced.

See also Colorado Interstate Gas Company, Docket No. TA81-1-32-000 (May 13, 1982), adopting Administrative Law Judge Leventhal's initial decision (1) rejecting the State of Texas' arguments that CIG's high-cost gas should be incrementally priced, (2) finding that "the Section 107 gas purchases were made to meet the needs of CIG's entire system and do not benefit only the low priority customers," and (3) holding that "[n]othing in the record in this case calls for deviation from the rolled-in cost allocation method." Initial Decision (April 7, 1982), at 25.

The Industrial Groups seriously doubt that incremental pricing would have been capable of achieving its stated goals even if the three developments cited by Laclede had not occurred. */ More importantly, however, Laclede's assertion that Title II was intended to drive "price-sensitive marginal users" off gas -- and that this would have been accomplished if only the statute had been correctly implemented -- is simply wrong.

Congressional proponents of incremental pricing expressly recognized the importance of implementing the program in such a way that industrial gas users would not switch to other fuels, and they declared emphatically that the incremental pricing program was not intended to drive industry away from using gas. For example, Congressman John Dingell, then

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*/ Moreover, the Industrial Groups believe that the FERC's adoption of the single-tier high-sulfur No. 6 oil cap and the House of Representatives' veto of Order No. 80 were prudent actions that were instrumental in mitigating the damage flowing from NGPA Title II.

Chairman of the House Energy and Power Subcommittee and floor manager of the bill, explained at length the various safeguards included in Title II in a specific effort to avoid industrial load loss. In this context, he declared:

> "[The conference agreement on Title II incremental pricing] will not drive industrial users off natural gas and on to other fuels. Such a result would be contrary to the very purposes of the bill's provisions. Incremental pricing is not intended to achieve conservation of natural gas through forced conversions of industrial users to other fuels. . . . If incremental pricing in fact drove industrial users to other fuels, the leverage these users have with pipeline management would be lost and the consumer protection aspects of incremental pricing would be seriously impaired." Cong. Rep. H 13114, col. 3 (daily ed. Oct. 14, 1978) (emphasis added). */

Laclede, therefore, can find no legitimate support in NGPA Title II for its own meat-axe proposal to force certain users out of the gas market.

(d) Laclede asserts that rolled-in pricing permits "price-sensitive marginal users" to demand more supply than they would if high-cost gas were marketed to them on a dollar-for-dollar, passthrough basis. (Laclede Ptn. at 8-9).

The cited assertion is, of course, unassailable as far as it goes. It it axiomatic that, so long as the rolled-in average cost of gas is less than the price of a given supply

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*/ See also colloquy between Senators Stone and Jackson at 124 Cong. Rec. S 16236 (daily ed. Sept. 27, 1978).

increment (whether deregulated gas, Section 102 gas, imported LNG, coal gas, or Section 107(c)(5) gas), consumers will demand more of that supply increment when priced on a rolled-in basis than they would if it were priced on a full cost basis. Similarly, if the price of that supply increment exceeds the price of substitutable goods or services, it is clear that the supply can only be marketed on a rolled-in basis. There can be little argument with these assertions. But, Laclede tells only part of the story when it applies these axioms _only_ to boiler fuel users.

It is, at best, a half-truth to state that "[t]his [boiler fuel] market would not exist if the full price of the [high-priced] gas had to be borne by the [boiler fuel] users." _Id_. What Laclede fails to state is that _all_ users -- not just boiler fuel users -- would reduce their demand for gas if they were faced with a price closer to its current full replacement cost. Boiler fuel users are _not_ the only "price-sensitive marginal users"; _all_ users are price-sensitive, and a portion of all users' gas use is "marginal use." It is true, of course, that, as users who can readily switch among alternate fuels, boiler fuel users can rapidly reduce their gas consumption to zero if the price of gas rises above the full cost of using alternate fuels. But _all_ users will reduce their consumption to some degree in the face of higher prices. A residential user, for example, could be expected to reduce his gas consumption (through greater insulation or otherwise) -- _i.e._, eliminate some of his marginal use -- when gas prices rise. (In fact, if gas prices were to rise high enough, it might be economic for the homeowner to seek another source of energy, such as the electric heat pump, which is becoming increasingly competitive with gas in residential markets.)

By definition, a portion of all users' consumption is "at the margin," and that portion is elastic to some degree. Certainly the energy policy debate has by now progressed beyond the myth that residential and commercial demand is inelastic; that myth cannot seriously be relied upon to support the arguments (1) that only boiler fuel users will "take advantage" of rolled-in pricing to demand more gas supply and, therefore, (2) that only boiler fuel users should be subject to a special incremental cost allocation scheme. Premised as they are on such a myth, those arguments should be decisively dismissed.

During the current transition to a deregulated market from a market in which wellhead prices have been kept artificially low for almost 30 years, it is inevitable that prices will rise; it is equally inevitable during this period that, if there is no mechanism to prevent pipelines from purchasing gas at prices higher than would prevail in a free market, the pipelines will most certainly do so. The key question, then, is what is the best mechanism to use during this transition period to restrain pipelines from purchasing gas at above-market-clearing levels but not to discourage them from buying gas at prices up to those which would prevail in a free market. Earlier in these comments, the Industrial Groups suggested several means which, in the absence of a far preferable legislative solution, might help accomplish these goals. Those mechanisms -- including effective implementation of the Commission's authority under NGPA Section 601(c)(2), and the conditional raising of "old" gas prices to higher "just and reasonable" levels, are intended to go directly to the heart of the Section 107 problem -- i.e., gradually to reduce the size of the "old" gas cushion but, at the same time, prevent deregulated gas prices from rising higher than they would in a truly free market. These transition period mechanisms are designed to encourage price movements which most closely resemble those which would occur in a free market. As prices increase, all users would find that some portion of their previous consumption level -- the "marginal" portion -- should be eliminated: for some users, this would mean the total elimination of their gas consumption after the price has reached a certain level; for other users, it would simply mean a partial reduction in their consumption, such as through greater efficiency of usage. At the same time, since pipelines would realize that they could not pass through to their customers those gas costs which exceed market-clearing levels, prices during the transition will not rise higher than the free-market levels. Such a result would be to the benefit of all gas users.

In contrast, Laclede seeks not to simulate the market during the difficult transition period to full decontrol, but rather simply to wipe out a portion of that market.

C. Sound Policy Reasons Continue To Support Rolled-In Pricing.

The Industrial Groups agree with California and Laclede that the prices which pipelines are paying for deregulated Section 107 gas are excessive and contrary to the interests of both natural gas consumers and the gas industry which serves them. It bears emphasis, however, that those excessive prices -- resulting from the inherently flawed structure of NGPA Title I -- are the real villain of the piece, not rolled-in pricing.

By proposing selectively to eliminate rolled-in pricing for boiler fuel users only (or simply to abandon service to such users), California and Laclede are suggesting that boiler fuel users should be singled out to pay for that NGPA flaw. The Industrial Groups believe that these proposals are unduly discriminatory and decidedly inferior to alternate ways of dealing with the Section 107 problem. */ Moreover, substantial policy reasons have traditionally supported, and continue to support, the use of rolled-in pricing.

The Commission has consistently employed the practice of rolling in the price of new increments of gas supply throughout the history of federal regulation of the natural gas indus-

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*/ See generally pages 36-84, supra.

try. */ Under the Commission's regulations concerning pipeline PGA clauses, all pipelines allocate purchased gas costs, including the costs of new or expensive gas supplies, on a rolled-in basis. 18 C.F.R. §154.34-38. Some of the advantages of rolled-in pricing which have formed the basis for this Commission policy were noted succinctly by Mr. Justice Reed, sitting by designation on the D.C. Circuit:

> "[Rolled-in pricing] recognizes that a gas pipeline...is not just a collection of discrete pieces and parts, but an integrated system serving all of its customers. Applying this approach the cost of the various assets of the system are collected or 'rolled-in' to arrive at cost of the entire system...."
>
> "This method has many apparent advantages and the Commission has repeatedly stated a general preference for it wherever it may equitably be used. It avoids the onerous administrative burden of having to assign a different portion of the cost to each of a large number of customers. It results, if all other factors be equal, in all customers paying the same price for gas taken from the pipeline at the same point, and _recognizes that all customers enjoy the benefits of having the whole gas gathering and pipeline system_." _Battle Creek Gas Company v. F.P.C._, 281 F.2d. 42, 46 (D.C. Cir. 1960) (emphasis added and citations omitted).

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*/ _See, e.g._, _Trunkline Gas Supply Company_, 8 F.P.C. 250 (1949); _Panhandle Eastern Pipeline Company_, 10 F.P.C. 185 (1951); _American Louisiana Pipeline Company_, 13 F.P.C. 380 (1954); _Trunkline Gas Company_, 21 F.P.C. 704 (1959); _El Paso Natural Gas Company_, 22 F.P.C. 260 (1959); _Kansas-Nebraska Natural Gas Company, Inc._, 25 F.P.C. 448 (1961); _Nueces Industrial Gas Company_, 45 F.P.C. 1224 (1971); _Columbia LNG Corporation_, 57 F.P.C. 354 (1977); _Trunkline LNG Company_, 58 F.P.C. 726 (1977); and _Colorado Interstate Gas Company_, Docket No. TA81-1-32-000 (May 13, 1982).

Notwithstanding the long-recognized benefits of rolled-in pricing -- which, presumably, even California and Laclede would subscribe to once all wellhead gas prices are in the neighborhood of market-clearing levels -- those two parties criticize the use of rolled-in pricing during the decontrol transition period because it does not allow distribution companies to reject specific supplies of high-cost gas with which they would prefer not to be encumbered. */ Implicit in California's and Laclede's arguments is the view that incremental pricing allows a distributor the freedom to choose whether (1) to assume the costs, risks, and benefits inherent in any particular supply increment, or (2) to forego purchasing that supply, reduce its own total gas requirements, and/or develop a supplemental supply of its own. Presumably, California and Laclede would argue that the advantage of such "freedom of choice" is that it avoids forcing a distribution customer and its end-users to accept a gas supply which they do not want.

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*/ This argument, of course, is considerably safer to make during a period when gas supplies appear to be abundant even without the high-cost gas. It may reasonably be expected, however, that in periods of comparative shortage, distribution companies would be somewhat less vocal in asserting the need for such a right of rejection. Insofar as the Industrial Groups do not share the views of some segments of the gas industry that the Golden Age of Gas Supply is here to stay, the comments in this section specifically reflect their cautious skepticism with respect to long-term supply stability in the gas market.

While perhaps appealing at first glance, the "freedom of choice" which California and Laclede apparently believe would attend the elimination of rolled-in pricing would be more illusory than real:

-- If the separately contracted-for gas supply were made subject to curtailment, a distributor would have little ability to match the costs and benefits of the particular supply source in order to determine whether to commit initially to purchase any supplies from that source. This is because, during any period of curtailment, distributors who initially refused to pay the costs of the particular supply increment would nevertheless be allowed to obtain the benefits of that supply for their high-priority loads. By the same token, distributors who did choose initially to assume the costs of the supply (by committing to purchase it) would be forced to assume also the entirely different risks taken by other distributors who chose not to contract initially for that supply. Thus, the potential benefits of separately contracting for (and committing to purchase) a specific supply are tremendously diluted by the fact that that supply can be diverted to other customers at the time of greatest need in the future. This bears absolutely no resemblance to the "freedom of choice" which a prospective purchaser of a commodity enjoys in any unregulated market. The Industrial Groups submit that this type of forced risk assumption involves a far more serious impingement upon a distributor's "freedom of choice" than does rolled-in pricing, which merely requires each customer to assume its proportional share of those gas supply costs whose incurrence has been found to be neither fraudulent nor abusive.

-- Even if supply increments offered on a separate, incremental basis were to be exempt from pipeline curtailment plans, there is no assurance that the distributor would actually get what it had paid for. The Commission has realistically conceded in the past that it cannot guarantee that future Commissions will not curtail even purportedly "noncurtailable" supplies in order to reallocate them to higher priority consumers at times when no other gas supply is available in a given market area. */ By the same token, it is not very likely that a state utility commission (e.g., California) would sit idly by if, during a severe supply shortage, residential users were cut off while large industrial boiler users continued to be served from "protected," earmarked supplies. Yet, as FERC has correctly noted, such a reallocation of separately contracted-for gas supplies would discriminate against those who had invested in those supplies "and subsequently were deprived of the benefits therefrom due to the needs of those who had not." Opinion No. 786, Columbia LNG Corp., supra, at 364.

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*/ See, e.g., Opinion No. 786, Columbia LNG Corp., Docket Nos. CP71-68 et al., 57 F.P.C. 354 (Jan. 21, 1977), at 363; Opinion No. 796-A, Trunkline LNG Company, Docket No. CP74-138, 58 F.P.C. 2935 (June 30, 1977), at 2941.

Laclede goes California one better by dispensing with even the illusion of distributor "freedom of choice". Instead, Laclede would resurrect the old proposal for "end-use rate schedules" and simply allocate all deregulated gas costs to users at the bottom of the curtailment hierarchy.

The concept of end-use rate schedules was deservedly criticized in literally scores of comments filed with the Commission in response to the Notice of Proposed Rulemaking issued in Docket No. RM75-19 on February 20, 1975. It may be recalled that there was an unusual display of unanimity among the varying interests which filed comments in that proceeding. The gist of those comments was that adoption of end-use rate schedules would constitute, inter alia, a substantial change from longstanding and court-approved Commission ratemaking practices, that their adoption would be contrary to the Natural Gas Act, that there was little or no assurance that the proposal would not cause irreparable harm to the gas industry and gas consumers, and that the rationale for the proposal was shortsighted, superficial, and invalid.

Since the Commission's Notice of Inquiry herein wisely did not invite comments on Laclede's proposed resurrection of end-use rate schedules, the Industrial Groups will gladly refrain from burdening these comments with the myriad arguments against such a proposal. */ Suffice it to say here that, among other things, such a proposal would have pipelines charge different rates to different customers for substantially the same product -- classic undue price discrimination against so-called "low priority" users in violation of Sections 4 and 5 of the Natural Gas Act.

Interestingly, Laclede appears to recognize that its so-called "marginal cost pricing principles" should, if applied at all, be applied to all users and uses of natural gas. (Laclede Ptn. at 14). Laclede wiggles out of this politically-sensitive dilemma, however, by suggesting that such an evenhanded application of its "principles" would be "virtually unmanageable." While the Industrial Groups agree that across-the-board application of incremental pricing **/ to all gas users (perhaps involving some type of inclining block design) would indeed be difficult, and while we oppose the adoption of any such program, we must emphasize that incremental pricing could pass legal muster only if it were implemented in this fashion. Therefore, at the very least, if Laclede's incremental pricing plan cannot be formulated in such a way as to confront all gas consumers with replacement cost "price signals", then the proposal should not be implemented at all.

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*/ See, e.g., Comments of General Motors Corporation and Comments of Indicated Industrial Gas Users, each filed June 2, 1975, in FPC Docket No. RM75-19.

**/ Despite its use of the term "marginal cost pricing", Laclede does not appear to be proposing true marginal cost pricing of natural gas at the pipeline level -- i.e., under which the pipeline would price every Mcf, regardless of when produced, at the cost of the last Mcf purchased. (Such a proposal, of course, would involve a whole host of different problems, even if implemented evenhandedly.) Rather, Laclede's proposal is more appropriately described as "incremental cost pricing", under which only the incremental supply is sold at the full cost of that increment. Nevertheless, even that pricing theory is significantly adulterated insofar as Laclede does not apply it to all consumers.

As previously discussed, all natural gas consumers have, by definition, certain identifiable levels of price-sensitive marginal demand. Some users (e.g., some boiler fuel users) have a single marginal demand point (i.e., at which they will stop purchasing gas altogether), while other gas consumers (e.g., residential users) have numerous successive marginal demand points at which, despite increasing inelasticity, they will reduce demand by additional increments. Accordingly, there is no sound reason why deregulated gas costs should be targeted only to some consumers' marginal demand and not to others. If it is important that gas users receive accurate price signals as to what current natural gas replacement costs are, then it is important that all consumers receive those signals. Singling out boiler fuel users as the only ones to receive replacement cost signals would be double discrimination:

(1) it would permit the loading of all deregulated gas costs on selected users only and thus allow pipelines and distributors to violate their service obligation to deliver adequate gas sup-

plies to all customers at the lowest reasonable rates, and

(2) it would give an undue preference to all other users whose rates, unburdened by any deregulated gas cost elements, remain artificially below even the gas supplier's average gas acquisition cost.

The transmission of accurate price signals is one of many goals which pipeline and utility rates should be designed to achieve. But distorted versions of incremental pricing which aim primarily to allocate costs among consumers on discriminatory, non-economic grounds should be firmly rejected. The forum for investigating legitimate proposals to achieve "price signal" goals is the pipeline rate design case, and the Commission has several such cases now pending in which the "price signal" issue can more appropriately and effectively be addressed. */

D. Proposed Abandonment of Certain Large Boiler Fuel Sales.

In its Petition for Rulemaking, Laclede also asked the Commission (1) to decline to approve any gas sale or transportation which would "permit a large-volume electric genera-

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*/ See, e.g., Natural Gas Pipeline Company of America, Docket No. RP81-49-000, in which several rate designs have been proposed which would unload pipeline fixed costs from tne commodity component and thus allow better cost/value communication between producers and end-users.

tion boiler fuel use," and (2) to require each pipeline to show cause why service to such uses should not be abandoned. (Laclede Ptn. at 16).

While none of the members of the Industrial Groups use gas for large-volume electric generation, and while the Industrial Groups believe that electric utilities currently have an unfair and unwarranted preference in gas service by virtue of their complete exemption from incremental pricing, we would not support either of Laclede's abandonment proposals. To be sure, the consumption of gas in electric utility boilers is a most inefficient manner in which to use natural gas. But for the maintenance of natural gas prices -- and especially rates to electric utilities -- at artificially-low levels, utilities would convert to non-premium fuels to generate electricity. Nevertheless, the Industrial Groups do not believe that the Commission should administratively force such uses off of natural gas.

In any event, the current price disparity between coal and other fuels has already provided some incentive for some electric utilities and other boiler fuel users to move to the use of coal as the primary fuel. Forecasts of even greater price differentials in the future -- due, for example, to the operation of the NGPA -- will ultimately move others to coal. It thus appears that many boiler fuel users -- especially those who operate in competitive markets -- will be forced increasingly to lower-priced energy sources, such as coal, or face continually eroding markets.

Thus, progress is already underway toward the important national objective of increasing the use of coal in non-premium uses where gas is currently used. That trend will continue as the natural gas market, impelled by market forces (and hopefully aided by remedial legislation) moves toward supply and price equilibrium. The Industrial Groups believe that this trend should be allowed to continue without FERC intervention to force abandonment of service to any class of gas consumer.*/

VII. CONCLUSION

In conclusion, the Industrial Groups urge the Commission to move promptly toward developing a balanced, comprehensive program for dealing with the serious economic problems engendered by the Natural Gas Policy Act of 1978. This Notice of Inquiry proceeding represents a promising first step; but, in the absence of sound legislation, definite administrative action will be necessary well before 1985.

In developing such a program, the Commission should carefully consider the proposals set forth in these and other comments, as well as the information being developed in the many rate-related proceedings before it. The Industrial Groups stand ready and willing to work further with the Commission in developing the needed program.

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*/ Since the Commission's Notice of Inquiry did not invite comments on these specific elements of Laclede's rulemaking petition, the Industrial Groups will refrain from commenting in detail on these proposals at this time.

Respectfully submitted,

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The Brick People, et al., and
The Georgia Industrial Group

August 26, 1982

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United States Senate
COMMITTEE ON
ENERGY AND NATURAL RESOURCES
WASHINGTON, D.C. 20510

January 3, 1983

Mr. Richard C. Perry
The Petrochemical Energy Group
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Dear Mr. Perry:

Attached are questions in follow-up to your appearance at the Committee's December 13, 1982 hearing on current conditions in the natural gas market. Please provide your responses to these questions to the Committee not later than the close of business January 17, 1983. If any clarification is needed you may contact Mr. Howard Useem (202-224-5205) of the Committee staff.

Sincerely,

James A. McClure

James A. McClure
Chairman

Enclosures

JAM:HU

QUESTIONS FROM REPUBLICAN MEMBERS OF THE COMMITTEE

1. In the Petrochemical Energy Group's opinion, what would be the effect of a price freeze on the reliability of your natural gas supplies?

2. In PEG's opinion, what impact would the various proposals currently pending before the Committee*/ have on:

   --residential, commercial and industrial gas prices?
   --short-term and long-term gas supplies?
   --the financial situation of producers, pipelines and gas distribution companies?

3. In PEG's opinion, to what extent and on what matters does the Federal Energy Regulatory Commission have the statutory authority to take action to address current and potential future problems in the gas market? Please provide the Committee with a detailed legal analysis of the FERC's authority. What actions would you recommend that the FERC take?

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*/ S. 2074; S. 2892; S. 3028; S. 3054; S. 3069; S. 3070; S. 3076; S. 3088.

QUESTIONS FROM DEMOCRATIC MEMBERS OF THE COMMITTEE

QUESTIONS FOR PEG (Richard C. Perry)

1. You state (on page 4) that the consumer does not pay the take-or-pay prepayment. Are you saying his bill would be the same even if take-or-pay prepayment clauses were outlawed? Why have we heard so much then about take or pay?

2. You state (on page 8) that the FERC already claims jurisdiction over pipelines' purchase decisions. Do you dispute that claim? Would you oppose a "least cost" gas purchase requirement?

PEG
The Petrochemical Energy Group
1701 Pennsylvania Avenue, N.W.
Washington, D. C. 20006
(202) 452-1880

SENATE COMMITTEE ON
ENERGY AND NATURAL RESOURCES
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JAN 1[illegible] 1983

January 13, 1983

The Honorable James A. McClure
United States Senate
3121 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator McClure:

This is in response to the questions presented in your letter of January 3, 1983, to Mr. Richard C. Perry of Union Carbide Corporation. Mr. Perry, along with Gordon Gooch, appeared as witnesses for the Petrochemical Energy Group (PEG) on December 13, 1982. Mr. Perry has asked PEG to respond to your letter. We are pleased to do so and appreciate the opportunity.

As a general matter, we want to reemphasize our group's strong opposition to piecemeal legislation on natural gas. We believe that comprehevsive legislation ending federal controls on both gas supply and gas demand offers the best hope of stabilizing prices and maintaining optimum supplies.

Sincerely,

Patrick H. McNamara

Patrick H. McNamara
Chairman

QUESTIONS FROM REPUBLICAN MEMBERS OF THE COMMITTEE

1. In the Petrochemical Energy Group's opinion, what would be the effect of a price freeze on the reliability of your natural gas supplies?

The primary outcome of a freeze may well be to reduce supply. As consumers dependent on natural gas for both fuel and raw materials we cannot be complacent about gas supply. As businessmen, it seems to us inescapable that freezing natural gas prices will reduce the incentive for exploration and development. Equally significant, a freeze of present NGPA prices will maintain the anomaly of capital being channeled into development of high-cost categories, such as deep and tight sands gas, and away from production and development of new OCS leases, new onshore wells and reservoirs, and new onshore production wells. The regulatory forces that currently channel capital in high cost directions would be frozen into place.

2. In PEG's opinion, what impact would the various proposals currently pending before the Committee */ have on:

-residential, commercial and industrial gas prices?
-short-term and long-term gas supplies?
-the financial situation of producers, pipelines and gas distribution companies?

We believe that the answers to these questions are covered in PEG's filed testimony and thus incorporate the answer by reference.

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*/ S. 2074; S. 2892; S. 3028; S. 3054; S. 3069; S. 3070; S. 3076; S. 3088.

3. In PEG's opinion, to what extent and on what matters does the Federal Energy Regulatory Commission have the statutory authority to take action to address current and potential future problems in the gas market? Please provide the Committee with a detailed legal analysis of the FERC's authority. What actions would you recommend that the FERC take?

The Federal Energy Regulatory Commission (FERC) has asserted the authority to review the purchasing practices of pipelines, apparently including whether least cost supplies are being purchased, whether contract terms with producers are prudent, and whether overall gas costs incurred by pipelines are "extravagant or unnecessary." 1/

A considerably more sweeping degree of control by FERC of pipeline practices has been held required by the Natural Gas Act (NGA) and the Natural Gas Policy Act (NGPA) in a December 30, 1982 Initial Decision on Purchased Gas Adjustment Filings issued by an administrative law judge at FERC to Columbia. 2/ The ALJ's order requires Columbia to refund amounts collected for the purchase of gas from all sources in excess of the take-or-pay level for the source "before cutting back any less expensive supply source." The order also denied tight sands pricing to Columbia's own pipeline production, requires Columbia to stop using its producer affiliate as a purchasing agent for the pipeline, requires Columbia to stop cutting back any less costly source

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1/ Tennessee Gas Pipeline Company, Docket Nos. TA82-2-9-000, et al., Order Denying Rehearing, October 1, 1982.

2/ Columbia Gas Transmission Corporation, Docket Nos. TA81-1-21-001, TA81-2-21-001, Presiding Administrative Law Judge's Initial Decision on Purchased Gas Adjustment Filings, December 30, 1982.

of gas until all more costly sources are cut to the minimum take and to "establish cutback practices which are consistent with the lowest reasonable rate standard of the NGA," requires Columbia to project its future gas acquisition policy on the basis of marketability on all customers' systems, not just on its own affiliates with a 2 oil standard, and requires Columbia, in the future, to desist from contract clauses which inhibit marketability. 3/ This decision is, of course, subject to review by both the Commission and the courts.

We also note that some Members of Congress have requested FERC to take action on the consumer price issue including the take-or-pay problem. 4/ In a statement of policy issued December 16, 1982, 5/ the Commission sought to discourage any take-or-pay provisions in contracts to be signed henceforth of levels above 75 percent and stated it was currently reviewing its policy and authorities with respect to take-or-pay provisions in existing contracts. Both legal and policy aspects of FERC's authority to address current gas market problems are treated, in some cases extensively, in the filed comments of some 169 companies, individuals and groups in response to FERC's broad Notice of Inquiry in Docket No. RM82-26. These comments are now being considered by the Commission as a basis for Commission action or recommendations to the Congress or both.

3/ Id.

4/ Letter to Hon. Charles M. Butler, Chairman, FERC, from Hon. Philip R. Sharp and Hon. John D. Dingell, dated December 6, 1982.

5/ Statement of Policy, Docket No. PL83-1-000, 47 Fed. Reg. 57268 (December 23, 1982).

The Commission has the authority to adjust certain prices of natural gas, primarily in the flowing gas category of §104 but with some effect on other categories, this subject also being addressed in the notice of inquiry, supra.

The Commission has the authority to determine that certain high cost gas supplies require a higher ceiling price.

The FERC has the authority to adjust the reference price for incremental pricing of natural gas to certain boiler fuel users.

The above is an attempt to catalogue some of the more significant powers vested or claimed to be vested in the FERC which can materially affect the natural gas situations.

PEG has recommended that the Commission use its authority over the price of flowing and other gas categories to mitigate the "cushion" problem which is the number one cause of market disorder under the NGPA.

QUESTIONS FROM DEMOCRATIC MEMBERS OF THE COMMITTEE

1. You state (on page 4) that the consumer does not pay the take-or-pay prepayment. Are you saying his bill would be the same even if take-or-pay prepayment clauses were outlawed? Why have we heard so much then about take-or-pay?

The consumer's bill may or may not be the same even if "take-or-pay prepayment" clauses were outlawed. It could be higher or lower, for the following reasons, among others.

First, as the recent Columbia decision indicates, the consumers' gas bill can be reduced even when take-or-pay contracts are honored.

Second, as we demonstrated in the testimony, the consumers' gas bill should be lower if the pipeline takes gas from cheaper sources and passes through the carrying charge on the most expensive gas and incurs take-or-pay. See page 9, note. Thus, the potential to lower the consumers' gas bill exists without further legislation.

Third, as the GAO report establishes, there are reasons other than take-or-pay clauses which might account for a pipeline's decision to run the most expensive gas. Thus, outlawing take-or-pay would not necessarily lead to lower gas prices.

Fourth, assuming that take-or-pay clauses are the cause of pipelines' taking the most expensive gas from producers, outlawing take-or-pay in producer contracts does not affect imports and production owned by pipelines (which, especially after the Mid-La 1/ decision, qualifies for all NGPA prices) and other sources of gas, such as SNG and purchases from other pipelines.

2. You state (on page 8) that the FERC already claims jurisdiction over pipelines' purchase decisions. Do you dispute that claim? Would you oppose a "least cost" gas purchase requirement?

PEG has taken no position on the scope of FERC jurisdiction referred to in our testimony or in the more recent decision in Columbia. The Columbia decision imposes a "least cost" gas purchase requirement. Removal of the NGPA's artificial wellhead pricing categories and the incentives they generate, so that all gas would be priced by market mechanisms, would eliminate the need for government analysis and regulation of pipelines on the scale required by a "least cost" requirement.

1/ Mid-Louisiana Gas Co. et al. v. FERC, 664 F.2d 530 (5th Cir. 1981), cert granted 51 U.S.L.W. 1051 (U.S. October 4, 1982) (No. 82-19).

APPENDIX II

Additional Statements and Communications Submitted for the Record

STATEMENT

OF

THE HONORABLE CHARLES E. GRASSLEY

I APPRECIATE HAVING THIS OPPORTUNITY TO SUBMIT TESTIMONY BEFORE THIS COMMITTEE ON THE URGENT PROBLEM OF NATURAL GAS PRICES. I WOULD LIKE TO COMMEND THE CHAIRMAN FOR HIS COOPERATION IN HOLDING THESE IMPORTANT HEARINGS AND FOR HIS ASSISTANCE IN PROVIDING THIS FORUM FOR DISCUSSION.

CONGRESS HAS NO SHORTAGE OF LEGISLATIVE REMEDIES TO OUR CURRENT NATURAL GAS PRICING SITUATION. I MYSELF, HAVE COSPONSORED TWO BILLS, S. 2982 AND S. 3076 WHICH LARGELY FOCUS ON THE CONTRACTS ENTERED IN TO BY PIPELINES AND PRODUCERS. SUCH AN APPROACH SEEMS TO HOLD MUCH MERIT IN ADDRESSING THE MARKET ANOMALIES WHEREBY GAS PRICES CONTINUE TO RISE DURING A TIME OF GAS SURPLUSES. THE ORIGIN OF THIS PARADOX IS TWO-FOLD: THE AFOREMENTIONED PIPELINE-PRODUCER CONTRACTS WHICH WERE NEGOTIATED DURING A FAR DIFFERENT ECONOMIC CLIMATE THAN CURRENTLY EXISTS; AND THE DISASTROUS PRICING STRUCTURE OF THE NATURAL GAS POLICY ACT. THE NATURAL GAS POLICY ACT, WHICH I VOTED AGAINST AS A MEMBER OF THE HOUSE OF REPRESENTATIVES, SHOULD BE A CONSTANT REMINDER TO ALL MEMBERS OF CONGRESS WHAT HAPPENS WHEN CONGRESS TRIES TO MANDATE APPROPRIATE PRICES FOR COMMODITIES.

IF CONGRESS IS SERIOUS ABOUT ADDRESSING THE TANGLED MESS OF NATURAL GAS PRICING, WE MUST BEGIN IN EARNEST TO EVALUATE THE WIDE RANGE OF OPTIONS AVAILABLE TO US. I REMAIN HOPEFUL THAT CONGRESS CAN ADOPT LONG TERM, CORRECTIVE LEGISLATION DURING THE FIRST SESSION OF THE NEXT CONGRESS. ALL INDICATIONS SUGGEST THAT CONCERNED PARTIES IN THIS NATURAL GAS DEBATE ARE FINALLY TO THE POINT OF REALIZING PROMPT ACTION IS NECESSARY TO RESTORE SOME SENSE OF ORDER TO THE NATURAL GAS MARKET.

IN VIEW OF CONGRESS' TRACK RECORD IN MARKET ORDERING LEGISLATION, WE MUST BE CAREFUL NOT TO ADOPT QUICK-FIX PROPOSALS WHICH WILL FURTHER DISTORT THIS MARKET. SOME OF THE AREAS OF ATTENTION I FEEL REQUIRE THE GREATEST SCRUTINY ARE THE INDEFINITE PRICE ESCALATORS, AND ABSURDLY HIGH TAKE-OR-PAY PROVISIONS. SINCE UNDER THE NGPA, PIPELINES WERE LIMITED IN THEIR AUTHORITY TO BID ON THE BASIS OF PRICE, THE PIPELINES UNDERSTANDABLY TURNED TO NEGOTIATING ON THE BASIS OF NON-PRICE ITEMS, INCLUDING HIGH TAKE-OR-PAYS, MOST FAVORED NATION CLAUSES, AND INDEFINITE PRICE ESCALATORS. IN THE AFTERMATH OF THE SHORTAGES OF THE 1970'S IT IS LITTLE WONDER THAT PIPELINES USED WHATEVER MEANS NECESSARY TO GUARANTEE LONG-TERM SUPPLIES WHERE AVAILABLE. NEITHER IS IT SURPRISING THAT PRODUCERS REQUIRED SUCH TERMS FOR THE USE OF THEIR PRECIOUS COMMODITY.

TODAY'S GAS MARKETPLACE IS HARDLY REFLECTIVE OF THE PROJECTIONS CONGRESS MADE DURING ITS CONSIDERATION OF THE 1978 NGPA. MY FOREMOST RECOMMENDATION ON THIS ISSUE IS TO ENCOURAGE A RE-NEGOTIATION OF THE MOST ONEROUS CONTRACTS. I HAVE RECEIVED SOME ENCOURAGING REPORTS THAT THE NATURAL GAS INDUSTRY IS BEGINNING TO SERIOUSLY MOVE IN THAT DIRECTION. I COMMEND THEIR EFFORTS THUS FAR, AND WOULD FERVENTLY REQUEST SUCH RE-NEGOTIATIONS CONTINUE. SUCH RENEGOTIATIONS WOULD ENABLE BOTH THE PIPELINES AND PRODUCERS TO SIT DOWN AT THE BARGAINING TABLE AND DECIDE WHAT CONTRACT PROVISIONS ARE REASONABLE IN PRESENT ECONOMIC CONDITIONS WITHOUT INTERFERENCE FROM THE FEDERAL GOVERNMENT. THROUGH THIS RENEGOTIATION PROCESS, THE INDUSTRY CAN SEND A STRONG SIGNAL TO CONSUMERS AND CONGRESS THAT IT IS BOTH CAPABLE AND WILLING TO HALT SPIRALING GAS COSTS.

ABSENT SUCH PRIVATE SECTOR INITIATIVES, CONGRESS AND, TO SOME DEGREE, THE FEDERAL ENERGY REGULATORY COMMISSION AND STATE RATE MAKING BODIES, MUST ACT AS RESPONSIBLE INTERVENERS TO CONTROL THE CONTINUAL HIKES IN NATURAL GAS PRICES. THE INDUSTRY SHOULD TAKE A LOOK AT SOME OF THE CREATIVE SOLUTIONS CURRENTLY BEING TRIED. NORTHERN NATURAL GAS, WHICH IS THE PRIME NATURAL GAS SUPPLIER TO IOWA, HAS AN AGREEMENT WITH

SOME OF ITS PRODUCERS TO PAY UP TO 20% OF ITS DEFICIENCY PAYMENTS RESULTING FROM TAKE-OR-PAY OBLIGATIONS AS A FEE FOR STORING GAS IN THE FIELD. THESE PAYMENTS HAVE SEVERAL BENEFITS INCLUDING FREEING UP THE PIPELINE'S FUNDS FOR PRODUCTIVE INVESTMENT PURPOSES, ALLOWING PRODUCERS TO COUNT THE PAYMENTS AS INCOME, AND LIMITING PROSPECTIVE PRICE INCREASES TO THE CONSUMER DUE TO ACCUMULATED DEFICIENCY PAYMENTS. CLEARLY, SUCH APPROACHES SERVE AS EXCELLENT EXAMPLES TO THE ENTIRE INDUSTRY AND I ENCOURAGE THE DEVELOPMENT OF OTHER INNOVATIVE SOLUTIONS.

AS AN ENERGY-DEPENDENT STATE, IOWA HAS A TREMENDOUS STAKE IN THIS NATIONAL ISSUE. IOWAN'S HAVE BEEN FACED WITH AN INCREASE IN THE PRICE OF NATURAL GAS OF APPROXIMATELY 100% OVER THE PAST THREE YEARS, AND IS PROJECTED TO SUFFER AN ADDITIONAL INCREASE OF 25% THIS YEAR. THESE PRICE HIKES COME EVEN THOUGH IOWANS HAVE BEEN EXTREMELY SUCCESSFUL IN THEIR CONSERVATION EFFORTS. IOWA'S REWARDS FOR SUCH EFFORTS HAVE BEEN STILL HIGHER GAS COSTS. MY STATE SERVES AS A PRIME EXAMPLE OF HOW THE NATURAL GAS MARKET IS NOT RESPONSIVE TO THE TRADITIONAL LAWS OF SUPPLY AND DEMAND.

ALTHOUGH IOWA IS NOT A GAS PRODUCING STATE, I WOULD BE REMISS IF I DID NOT CONSIDER THE IMPACT CHANGES IN CURRENT LAW WOULD HAVE ON THE PRODUCERS. ONE OF THE FEW POSITIVE EFFECTS OF THE NGPA WAS INCREASED EXPLORATION AND PRODUCTION, AND MANY PRODUCERS ENTERED THE BUSINESS, OR EXPANDED THEIR OPERATIONS, WITH FULL EXPECTATION THAT THE NGPA PRICE STRUCTURE WOULD BE CARRIED THROUGH. MANY SMALL INDEPENDENT PRODUCERS ARE HEAVILY LEVERAGED, AND WOULD BE THE FIRST TO FEEL THE IMPACT OF PRICING ADJUSTMENTS. A RELATED CONCERN IS THE LONG-RANGE EFFECT ANY LEGISLATIVE CHANGES WOULD HAVE ON SUPPLY. CONGRESS SHOULD IN NO WAY ADOPT MEASURES WHICH WOULD LEGISLATE THE NATION BACK INTO SHORTAGE SITUATIONS. OUR FOCUS MUST BE ON METHODS TO ENSURE AMPLE NATURAL GAS SUPPLIES AT MARKET CLEARING PRICES. WE NOW HAVE AMPLE AND EVEN SURPLUS GAS, BUT IN FAR TOO-MANY INSTANCES THE COST OF OBTAINING THAT GAS IS IN EXCESS OF THE MARKET-CLEARING PRICE.

THE NATURAL GAS INDUSTRY HAS A LONG HISTORY OF REGULATION, AND EVEN UNDER THE TERMS OF THE NGPA, ONLY 40% OF TODAY'S GAS RESERVES WILL BE DECONTROLLED IN 1985. THE TIME FOR PLACING BLAME IS OVER. THE INDUSTRY, CONSUMERS, THE ADMINISTRATION, AND CONGRESS MUST ALL COORDINATE IDEAS AND EFFORTS TO FORMULATE PALATABLE ALTERNATIVES. THIS HEARING IS A VALUABLE START. IT WILL TAKE A CONCERTED EFFORT TO REACH AGREEMENT ON SOLUTIONS TO THE NATURAL GAS PRICING PROBLEM. WE ARE ONLY NOW BEGINNING TO GRASP THE TREMENDOUS COMPLEXITIES AND DEPTH OF THE ISSUES INVOLVED. NEVERTHELESS, WE ARE MOVING FORWARD, AND THE COMMITMENT TO PROGRESS MUST CARRY OVER TO THE UPCOMING YEAR.

STATEMENT OF REP. LARRY WINN, JR. (R.KANS.)
SENATE COMMITTEE ON ENERGY AND NATURAL RESOURCES
Monday, December 13, 1982

MR. CHAIRMAN and distinguished members of the Committee I appreciate the opportunity to present this statement for the Committee's hearing record on the crucial issue of rising natural gas prices. I want to commend the Chairman and the Committee for scheduling this hearing to receive testimony about the impact of rapidly-rising price increases on residential consumers and about the defects and problems in the Natural Gas Policy Act of 1978 and the industry which have contributed to this situation.

On November 29 I introduced a resolution in the House of Representatives which urges the House Leadership and the Committee Chairmen having jurisdiction to consider and act on the dramatic rise in the price of natural and propane gas. We can discuss and debate indefinitely the complexities and controversies of this problem--as those of us who were here in 1977 and 1978 recall--but our actions speak louder than words. This hearing, Mr. Chairman, is a proper step in responding to the pleas of our constituencies. The House Energy and Commerce Subcommittee on Fossil and Synthetic Fuels has scheduled a similar hearing on December 15, at which I will testify, and I am very pleased that time has been set aside in the crowded agendas of both the House and Senate to hear Members of Congress present their views and suggestions.

Since last January I have been receiving regularly letters from residential gas consumers in my 3rd Congressional District--and many from other areas of Kansas as well--protesting their escalating monthly gas bills. Within the last two and a half months alone, I have received nearly 2000 communications. But as I was reminded last week by a visiting constituent, "You haven't seen anything yet; wait until the snow starts flying."

What we are talking about here today is an issue that hits right at the pocketbook of the public. People are making the decision right now on whether to keep warm or eat. It is that serious. Over 6000 residences have had their gas turned off for failure to pay their bills. Furthermore, people who in the past have had little difficulty in paying utility bills are also suffering as well as the poor. The magnitude of the problem is frightening.

The residents in my District may pay as much as $50 to $100 or more per month this winter. Even by employing various means to conserve and save on the amount of gas used, monthly costs have continued to rise.

The impact of higher prices is equally as significant on non-residential sectors. I've been told that some churches are not using heat at all in order to save money. The commercial sector, educational institutions and hospitals are also feeling the pinch of higher energy costs which are inflationary and are ultimately passed on to the end-user. In a recent study updated by the American Gas Association, educational, health services and non-residential apartments or buildings represent almost 40 percent of the U.S. commercial gas sales volume. In the past two years, as reported by one of our local news media, the cost of heating the Kansas City, Kansas Public Schools with natural gas has more than doubled in the past two school years. The Shawnee Mission Public Schools have reported a 52 percent increase in the 1981-82 school year. Recent data which was provided to me by Rockhurst College in the Kansas City area shows that despite considerable effort and expense to successfully achieve a 25 percent reduction in energy over a four-year period from 1979 through 1982 total MCF usage has decreased 23.28 percent while total costs have increased 84.52 percent.

Consistently, Congress is being called upon to consider and act on some type of legislation which will deal immediately with this winter's price increases. Many also ask that the NGPA be changed, as well as the contractual obligations between pipelines and producers, namely, the take-or-pay clauses. In addition, a good portion of the comments I've had reflect bewilderment and anger over the current situation in the Kansas gas market. While our State is being flooded with high-priced supplies, — lower-priced Kansas gas is not moving. On two occasions I've been contacted by small producers who have drilled and struck natural gas but cannot locate a buyer. Petition drives are underway throughout the state, gathering thousands of signatures, calling for major revisions in the NGPA. The Gas Service Co., a major gas distributor in Kansas, Missouri, Nebraska and Oklahoma has widely circulated its suggestions for legislative and contractual revisions, including the repeal of all pricing formulas in the 1978 Act; reasonable limitation on pre-NGPA gas price increases; elimination of indefinite price escalator clauses; and elimination of unreasonable take-or-pay provisions from post-NGPA gas production contracts.

In the past several weeks I have followed with considerable interest in my District and in the Kansas City area the very commendable efforts underway to assist thousands of households without heat and residents who need temporary aid. The local response by private groups, social service organizations, churches and city and county governments has been very gratifying. A local television telethon has received more than $200,000 in pledges from the public. But obviously, Congress did not intend, in its enactment of the NGPA, that such a remedy would be needed to deal with unrealistic price increases. This situation clearly emphasizes the problems in the statute and in the industry which now require Congressional attention.

I want to mention, too, that in Kansas the Federally assisted Low-Income Energy Assistance Program will provide, based on published reports, about $11.3 million for heat aid through the Kansas Department of Social Rehabilitation Services. In continuing support of this program, I have joined a large bipartisan group of House Members in requesting the President to earmark adequate funding in the FY 1984 budget. As many of you know, a number of bills have been introduced in both the House and Senate which deal with the problems in the natural gas market as well as defects in the NGPA. Many of them express valid concerns and offer good solutions to a difficult problem. But they mostly deal with long-term solutions. I hope that Congress can act quickly and decisively to push legislation which will help people through this winter.

Thank you again, Mr. Chairman and Members of the Committee for the opportunity to include my remarks in the printed record.

Official Committee File

ncjc
National Oil Jobbers Council
1707 H Street, N.W., 11th Floor
Washington, D.C. 20006 · 202/331-1198

December 17, 1982

SENATE COMMITTEE ON
ENERGY AND NATURAL RESOURCES
RECEIVED
DEC 20 1982
WASHINGTON, D.C. 20510

The Honorable James A. McClure
Committee on Energy & Natural Resourc
3104 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

On behalf of the National Oil Jobbers Council (NOJC) I would like to submit the following comments for inclusion into the record of the committee's hearing taking place in Washington, D.C. on December 13, regarding the current situation in the natural gas marketplace.

The NOJC is a national federation of 42 regional and state associations representing more than 15,000 independent small business petroleum marketers. NOJC member companies market more than 85 percent of the home heating fuels and more than 50 percent of the gasoline sold annually in the United States.

The NOJC congratulates you and the Senate Energy & Natural Resources Committee for your interest in this most vital issue and in our segment of the petroleum industry.

Today the competitive viability of thousands of small business petroleum marketers is at stake. Distillate fuel oil used by millions of American consumers for residential heating has been deregulated since 1976. The small business heating oil dealer must compete against the natural gas utility, whose product is artificially priced well below its true market value by the Natural Gas Policy Act (NGPA). The NGPA effectively legalizes predatory pricing, forcing hundreds of heating oil dealers out of business and seriously jeopardizing the heating oil distribution system. Because petroleum, natural gas and coal are our prime sources of energy, energy policy should promote the efficient use of these fuels by allowing them to compete in the market priced according to their merits. Only with a consistent policy which efficiently utilizes all our energy resources at their true costs will be able to obtain energy security and best serve the needs of the consumer.

The artificial subsidization of natural gas prices discriminates against the 16 million residential consumers of home heating oil throughout the country who are paying full price for their energy needs. Home heating oil consumers have been meeting the challenge of higher energy cost through more efficient use of the energy they purchase. Meanwhile, their neighbors using natural gas continue their wasteful consumption of a nonrenewable energy resource because natural gas is priced below its true value. To the consumer, the value of a fuel is not only the cost of this fuel itself, but the value of the warmth it provides. The value of this warmth is the same, no matter the source. The preferential treatment of the residential user of natural gas is grossly unfair to those consumers who heat their homes with electricity or heating oil.

A Federation of Independent Petroleum Marketers Founded in 1941
Merged with the National Oil Fuel Institute in 1974.

Curtailment: The Gas Industry's Hidden Source of Supply

The decade of the seventies brought serious set-backs for the natural gas industry. Market shares in residential space heating, in electricity generation, and in industrial fuel use fell dramatically. In the Winter of 1976-1977, America experienced the shock of a major gas shortage. Schools, hospitals, and industries were shut down, lives endangered. In times of short supply natural gas piepeline and distribution companies resorts to curtailment, which is defined as a reduction in deliveries from contract quantities, from normal historical quantities, or from other bases a supplier may select. Today, a curtailment priority system exists which protects essential agricultural and other high priority uses of natural gas while other uses are curtailed.

In times of curtailed natural gas use, consumers turn to heating oil and residual fuel oil. In spite of years of curtailments in supplies, the natural gas industry continues to spend million of dollars annually to gain new customers.

The historical use of curtailments and the need to supply customers on an "interruptible" basis believe the claims of surplus supply being extolled in the campaign to gain additional customers, both high-priority and low, for the natural gas industry. Today, natural gas industry officials are cautioning federal policy makers not to misinterpret the current natural gas "surplus" as anything other than temporary.

We look forward to working with your Committee early in the 98th Congress to address the inequities created by current natural gas policy.

Sincerely,

Mark O. Decker

Mark O. Decker
Vice President

MD:ms

OPCON

Operational Economics, Inc.
802 West Alabama / Houston, Texas 77006
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Natural Gas Prices

by

Russell G. Thompson
Chm., Pres. & C.E.O.
Operational Economics, Inc.

Natural gas prices are going through the roof. Consumers feel they are being ripped-off. Policymakers are proposing price freezes.

No one seems to be asking, "Why are prices rising so much?" "What would happen if the Government was not involved?" Is it possible that the Government is the villain rather than the savior? Yes, our analyses show that this is exactly the case today in natural gas pricing.

The Natural Gas Policy Act of 1978 is picking the consumers' pockets. This probably results from an unforeseen error of omission, not an error of commission. When the Act was legislated, it must have been assumed that the supply of shallow, regulated gas would continue to totally dominate the price. But, this premise is no longer valid. Because of the way the Act modified the economics, producers rushed to drill many deep wells. This gas brought very high prices in the unregulated market relative to the regulated supplies. Its value in the marketplace now represents 20% of the per unit cost paid by the consumer. This growth in relative value importance was enough to fundamentally change the overall market economics. Costs of supplying gas to the consumer, on the average, are now rising faster than what the overall incremental costs of additional gas supplies would rise in the absence of regulation. Why? Because the shallow, low-cost gas which would have been produced in the absence of the regulations was not economic, given the Law. The policymaker who told the consumers he was acting in their best interests actually was not; he either neglected to tell them the truth or he did not understand what he was legislating. It seems difficult to believe the latter considering the straightforward logic of the situation, but as Barnum and Bailey always said, "A fool is born every minute."

Everyone knows that it costs less to drill shallow wells than deep ones. Yet, the NGPA stimulates deep drilling, not shallow. The consumer is now paying the bills for this foolishness. Natural gas prices would fall in the near term if new gas prices (Section 102) were deregulated. In the long term, gas prices to the consumer would rise less without these NGPA controls than with them.

OPCON's in-depth analysis, which is available to subscribers, definitely documents this landmark finding. In addition to household users, industrial consumers would also benefit from lower gas prices. These lower prices would decrease production costs, increase competitiveness, stimulate employment and lower prices in general. These lower prices also would cut fuel costs for electric utilities, thereby decreasing electricity costs.

However, certain vested interests are benefiting from the legislated regulatory pickpocket. The regulations create unproductive jobs for many in government. Also, they create highly-favorable loopholes for the gas utilities. And, they create profit-making opportunities for the deep-gas producer and all of his suppliers.

Surprising as it may seem, the informed consumer and the low-cost, shallow gas producers have the same policy interest. Immediately deregulate new gas prices and reap the mutual economic benefits from "arresting the regulatory pickpocket." Then, when the gas prices actually fall, stand by for the show and tell of those who legislated the NGPA. Their act will become increasingly interesting as the new political phalanx forms.

American Farm Bureau Federation

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AREA CODE 202 - 484-[illegible]

December 8, 1982

SENATE COMMITTEE ON
ENERGY AND NATURAL RESOURCES
RECEIVED
DEC 8 1982
RECEIVED
WASHINGTON, D.C. 20510

Honorable James McClure, Chairman
Senate Energy and Natural Resources Committee
3106 Dirksen Senate Office Building
Washington, DC 20510

Dear Senator McClure:

Farm Bureau wishes to submit for the record our views on the decontrol of natural gas prices.

Farm Bureau is the nation's largest general farm organization with over 3 million voluntary member families in 48 states and Puerto Rico. Our working farmers and ranchers produce about 75 percent of the nation's commercial agricultural commodities of virtually every kind and description.

Farm Bureau policy for 1982 provides in pertinent part as follows:

> "One of the most critical problems facing our nation is the availability of adequate supplies of energy. Development and implementation of a comprehensive national energy policy should be a high priority legislative goal for the Administration and the Congress. It is imperative to the nation's long-term best interest that government and private industry work cooperatively and immediately to develop all possible sources of energy.
>
> "Bureaucratic interference in the energy market should be eliminated and the Department of Energy should be abolished. Government regulations and punitive taxes levied on energy producers only serve to make the United States more dependent on foreign nations to supply our energy needs. Congress should encourage capital investment for the development of domestic oil and gas exploration by the competitive enterprise system and deregulation."

Natural gas is used at many points in the production, processing and marketing of agricultural commodities and food products. Natural gas utilization for fertilizer production, particularly ammonia, is especially important. Nitrogen fertilizer has been one of the most significant factors in the growth of agricultural productivity in this country. Nearly 95 percent of the anhydrous ammonia produced in the United States uses natural gas for its manufacture.

Since 1954, the federal government has regulated wellhead gas prices at levels below competitive energy prices. This overstimulated demand, understated supply and led to an imbalance in the gas market. The Natural Gas Policy Act of 1978 is decontrolling prices for certain categories of natural gas through a phased-in program of monthly price escalations. Generally, controls on gas discovered after 1977 are to be ended by January 1985, while gas discovered before 1977 will remain under price control indefinitely. Approximately 40 percent of all natural gas will remain price controlled. Thus, the current 1978 Decontrol Act is really only a partial decontrol. (This is a gross generalization of a very complex regulatory situation which currently has 20 categories of natural gas and legions of rules.)

The administration had considered a total phase-out over three years of all federal controls on the prices of all categories of natural gas, but has now apparently abandoned this plan. Congress has considered accelerating gas deregulation with an accompanying windfall profits tax. A tax on the additional revenues would reduce incentives for new exploration efforts and would force distribution companies into the unwanted role of tax collection agencies.

Natural gas is a basic energy source and a close substitute for other energy sources. In a free market, close energy substitutes will have close to equivalent prices in terms of units of energy. In January 1982, crude oil prices were about $34 per barrel. If natural gas were priced equal to oil on an equivalent energy basis it would average $6.20 per thousand cubic feet at the wellhead. Federal government price controls have held the current average wellhead price at less than $2.00 per thousand cubic feet.

Regardless of whether sharper decontrol measures are enacted or whether the 1978 act stands as is, the general effect will be an increase of natural gas prices. In 1985, the average price of gas should rise to an energy equivalent price, though there may still be wide price spreads between gas categories.

Energy conservation and expanded supplies of energy resources have been holding energy prices constant, if not slowly reducing energy prices. Rising natural gas prices also will cause gas users to conserve gas and gas producers to increase exploration and supply. This will put downward pressure on rising gas prices. Barring unforeseen political events or technical developments, $6.00 per thousand cubic feet of natural gas is a sound forecast for 1985.

Using a gas price of $6.00 per thousand cubic feet, fertilizer experts have projected a 1985 average price to farmers for anhydrous ammonia of $430 per ton, compared with estimated average spring 1982 price of $255. The $430 per ton ammonia price will cover production costs, overhead costs, distribution costs, and provide a nominal level of return on the investment of the ammonia producer. Seventy-five to 85 percent of the price increase will be due to the increase of natural gas prices. The remainder will be due to other cost increases. Some reports give estimated ammonia prices of $600 and $800 per ton by 1985. These estimates are based on assumptions of $50 barrel crude oil. This assumption is quite speculative in view of today's energy situation.

Fertilizer prices are responsive to shifts in supply and demand. Anhydrous ammonia prices per ton have risen from $87.60 in 1973 to $265 in 1975, fallen to $171 in 1978 and risen again to current levels. Only in three of the past ten years has the anhydrous ammonia industry made a nominal return on investment. Even a $430 per ton price may not be sufficient to entice investment in needed new production capacity.

What does the $430 per ton ammonia mean to crop production costs? Using current average yields and current average nitrogen application rates, it gives an added cost of 14 to 20 cents per bushel of corn, 2 to 3 cents per pound of cotton and 16 to 20 cents per bushel of wheat. This cost accounting assumes that only the nitrogen price increases and that all else remains the same; but, in fact, all else will not remain the same. There will be short-run adjustments in nitrogen use and longer-term adjustments in commodity prices.

Even if prices rise enough to cover the extra cost, farmers will use less fertilizer simply because it improves profits. An income maximizing producer will increase nitrogen use until the cost of the additional fertilizer needed to produce an additional bushel of grain is equal to the value of the additional bushel. Unless product price increases match the ammonia price increase, nitrogen fertilizer use will decline. Reduced nitrogen use will reduce expenses and reduce yields. The reduced production will strengthen commodity prices. With higher nitrogen prices, there will be new incentives to improve the efficiency of nitrogen utilization and to find new methods of nitrogen production. The reduced demand for nitrogen may even cause a short-run reduction in nitrogen prices. These interactions of supply, demand, price, technology and production will soften the negative income effect of the increased ammonia cost.

Economic theory says anytime the price of a resource is kept below its market price, the resource will be used inefficiently. Ammonia production uses less than three percent of the natural gas consumed in the U.S. The whole economy cannot be asked to continue a burdensome and economically inefficient regulatory system for the private benefit of a few users.

Last year for the first time since the early 1960's, more reserves of natural gas were discovered in the U.S. than were used. As rising natural gas prices spur domestic production, the more plentiful supplies will tend to moderate price increases and reduce the importation of foreign energy. Ultimately, our whole economy will benefit from total decontrol of all natural gas.

Thank you for this opportunity to present our view on this most important matter.

Sincerely,

John Datt

John C. Datt
Secretary and Director
Washington Office

lh
cc: Committee Members

CMA

CHEMICAL MANUFACTURERS ASSOCIATION

ROBERT A. ROLAND
President

December 22, 1982

The Honorable James A. McClure
Chairman
Committee on Energy and Natural Resources
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Our comments on current natural gas issues are enclosed. We ask that these comments be included in the December 13, 1982 hearing record of the Senate Committee on Energy and Natural Resources.

We recommend that the Congress deal with natural gas deregulation in a comprehensive manner early in the 1983 legislative session. We urge you to reject piecemeal proposals that would freeze wellhead prices, extend price controls, and abrogate certain existing natural gas contract provisions.

The state of the economy would improve, and consumers would benefit from total phased deregulation of all natural gas wellhead ceiling prices and removal of gas market restrictions such as incremental pricing, Fuel Use Act prohibitions, and restrictions on access to supplies.

As the group representing the largest industrial consuming sector of natural gas, we look forward to again participating in the hearing process, and would welcome any opportunity to provide information gained from our experience in the marketplace.

Sincerely,

Enclosure

Formerly Manufacturing Chemists Association—Serving the Chemical Industry Since 1872.
2501 M Street, NW • Washington, DC 20037 • Telephone 202/887-1106 • Telex 89617 (CMA WSH)

Comments of the
Chemical Manufacturers Association
to the Senate Committee
on Energy and Natural Resources
Concerning Natural Gas Issues

December 13, 1982

The Chemical Manufacturers Association (CMA) is a nonprofit trade association whose company members represent more than 90% of the productive capacity of basic industrial chemicals within this country. As the largest industrial consumer of natural gas, CMA members consume over 10% of the total U.S. natural gas and 25% of all gas used by industry. Over half of chemical industry use, approximately one trillion cubic feet per year, is essentially non-substitutable. Our members depend upon both the intrastate and interstate natural gas systems for supply.

CMA strongly opposes recent natural gas legislative proposals that would freeze wellhead ceiling prices, extend price controls, and abrogate certain existing contract provisions. A "quick fix" approach to legislative complexities of the natural gas market would be detrimental to consumers and our nation's economy. Complex natural gas issues must be dealt with in a comprehensive manner, and not by any piecemeal approach.

Existing law has resulted in price anomalies and market disorders. The Natural Gas Act (NGA) and the Natural Gas Policy Act (NGPA) distort natural gas prices, discourage production from the least-cost sources, unfairly reward certain U.S. producers, and subsidize imported gas.

Legislation to freeze wellhead prices and extend controls, however, is not the answer. Such measures would not solve, but would even worsen the present problems. Basic deficiencies of the price freeze proposals are as follows:

- A wellhead price freeze would not give significant price relief to consumers.
- A price freeze and extended controls would lead to shortages.
- Continuing regulation would perpetuate price anomalies and market disorders caused by existing law.

Instead of more regulation, these problems can best be resolved by total phased deregulation of all natural gas, and removal of gas market restrictions. The current anomalies and disorders could not exist in a free market.

Government and industry analyses confirm that gas prices would actually be lower under total deregulation than they would be under continued, or extended regulation. Total deregulation is the best way to help reduce consumer gas bills.

These points are discussed in more detail in the following sections:

- A Wellhead Price Freeze Would Not Give Significant Price Relief To Consumers

The driving force for the price freeze proposals is purported to be relief for gas consumers faced with increased heating costs.

The proposed legislation, however, would not provide significant relief. Moreover, these proposals would damage the economy, including the petrochemical sector.

Wellhead natural gas price increases now under debate account for only a fraction of the increase in consumer gas prices, according to federal government information. The September 1982 Energy Information Monthly Energy Review reports that average consumer gas price over a twelve-month period (June 1981 to May 1982) increased by $1.07 per thousand cubic feet, while wellhead price increases averaged only 34¢ per thousand cubic feet over the same period. Also, some of the 34¢ increase in average wellhead price is due to consumption of low-cost gas from old wells, and replacement by higher-priced categories.

Secretary of Energy, Donald P. Hodel, has stated recently that calculations indicate pending proposals to freeze natural gas prices would save, perhaps, 2% on natural gas prices, and proposals aimed at "take-or-pay" gas control provisions might reduce prices another 1 or 2%.

- A Price Freeze And Extended Controls Would Lead To Shortages

Price freezes and over-regulation have been demonstrated to be a cause of shortages. Legislation to freeze prices and extend price controls would send a clear signal to gas producers that Congress is more interested in allocating shortages than encouraging domestic energy production that would reduce overall fuel costs to consumers. For example, in 1977, control of interstate gas prices at essentially freeze levels resulted in severe shortages. School and factories were shut down when their supply of interstate gas was curtailed while gas was plentiful in intrastate markets that were not subject to price controls.

The NGPA was introduced to overcome the shortcomings of price control regulations of the NGA. While Congress was correct in attempting to address the natural gas issues in 1978, the NGPA was deficient, and continues to demonstrate that regulations cannot order markets. Only the free market can solve supply and demand problems too complex for any of us to predict. Under the NGPA, there is a "shortage" of lower-cost, price-controlled gas. Lower-cost gas is shut in, and flared in some instances. Pipelines are marketing gas from higher-cost sources, and restricting sales of low-cost gas because of certain contractual obligations that occurred in a regulated market.

- Continuing Regulation Would Perpetuate Price Anomalies And Market Disorders Caused By Existing Law

Price and market disorders are caused by continued gas regulation, creating pricing disparities that do not reflect rational competitive market conditions. These disparities are detrimental to the economy, and to most segments of the natural gas-producing distributing, and consuming industries, as well as residential and commercial consumers.

A previous review of natural gas prices paid by interstate pipelines indicated that the highest price for Section 107 gas was more than twenty times the price paid for "old gas". Clearly, this price variance for the same commodity is at odds with experience in other unregulated energy markets which reflect a more rational discipline because of competitive forces.

Higher energy cost plants and products are at a distinct disadvantage in competing for new investments, and hence, new jobs within industry. Not only will these plants have difficulty attracting new investment, they will experience declining investments and jobs as the recession-induced manufacturing curtailments cause reconsideration of continued operation of these marginal facilities.

Natural gas deregulation and removal of gas market restrictions will reduce regional pricing disparities under the NGPA, and improve resource allocation. Domestic gas supplies will be enhanced, resulting in reduced high-cost energy imports, and increased economic activity.

- Deregulation Would Benefit Consumers

Many claims have been made that deregulation will increase average consumer gas prices. Not only have the costs of deregulation been exaggerated in the past, but most analysts now believe that market forces would reduce prices below those anticipated by the NGPA if gas prices were deregulated. This has been recently stated by C. M. Butler, Chairman of the Federal Energy Regulatory Commission, and confirmed by updated chemical industry estimates.

Consumers want adequate supplies at equitable prices. Unless gas is available to industry on a predictable, nondiscriminatory basis, the price of gas to residential consumers will escalate rapidly under regulation, as many industrial users switch to lower-cost alternative fuels. Less industrial use results in increased pipeline and distribution costs for residential consumers.

Under a deregulated market, producers will be encouraged to fully develop the lowest-cost gas resources. Recent experience with oil price deregulation indicates that although prices may rise slightly for a short period, they level off as the market comes into supply/demand equilibrium. Similarly, if market forces were allowed to freely operate, the present surplus of natural gas would drive gas prices down, just as oil deregulation led to reduced prices. Therefore, deregulation would benefit consumers.

- Conclusion

In summary, freezing wellhead ceiling prices, extending price controls, and abrogating certain contract provisions will not solve consumer price problems. Regulatory adjustments may attempt to treat the symptoms of the problem, but only free market forces can solve the problem by ordering markets efficiently. Deregulation is the only practical way to eliminate the price anomalies and market disorders created by existing legislation. Deregulation will result in lower average prices than will be experienced if gas regulations are retained or extended.

November 17, 1982

The undersigned organizations have collected for your review their respective policy positions on natural gas deregulation.

American Farm Bureau Federation
American Mining Congress
American Paper Institute
American Textile Manufacturers Institute
Business Roundtable
Chamber of Commerce of the United States
Chemical Manufacturers Association
Council of Industrial Boiler Owners
Highway Users Federation
Independent Petroleum Association of America
National Association of Manufacturers
National Cattlemen's Association
National Coal Association
National Grange
National Oil Jobbers Council
National Petroleum Refiners Association
Natural Gas Supply Association
Petrochemical Energy Group
Process Gas Consumers Group
Society of the Plastics Industry

American Farm Bureau Federation

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1982 NATURAL GAS DECONTROL AND ENERGY DEVELOPMENT POLICY

One of the most critical problems facing our nation is the availability of adequate supplies of energy. Development and implementation of a comprehensive national energy policy should be a high priority legislative goal for the administration and the Congress. It is imperative to the nation's long-term best interest that government and private industry work cooperatively and immediately to develop all possible sources of energy.

Bureaucratic interferences in the energy market should be eliminated and the Department of Energy should be abolished. Government regulations and punitive taxes levied on energy producers only serve to make the United States more dependent on foreign nations to supply our energy needs. Congress should encourage capital investment for the development of domestic oil and gas exploration by the competitive enterprise system and deregulation.

We urge repeal of the so-called windfall profits tax.

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• Raymond E. Salvati, Ft. Lauderdale
• Ian MacGregor, Greenwich

• Immediate Past Chairman
• Honorary

ENERGY RESOURCES

Dependence of the United States on politically insecure and price-volatile foreign oil supplies increases the nation's vulnerability to supply interruptions, undermines national security, hurts balance of payments, and compromises foreign policy. In light of this, the present excess supply of foreign oil should not be allowed to stall the drive to increase domestic supplies of conventional energy and to begin sustained efforts to develop alternative fuels.

The American Mining Congress endorses an energy program that will lead to greater national energy independence while recognizing that energy development is a global concern. Development of additional supplies of domestic energy should have high priority in national policy-making along with cost-efficient regulations designed to protect the environment and provide for worker health and safety.

AMC believes that efficient domestic production, including alternative fuels, and conservation of energy are in the national interest. Specifically, it supports the following:

Oil and Gas

- Accelerated leasing of prospective state and federally controlled oil- and gas-producing areas.
- Accelerated decontrol of natural gas prices.
- A mechanism for the federal government to make a finding of "national interest" to allow accelerated approval of energy developments.
- Continued strategic storage to protect the nation from oil import interruptions.

October 10, 1982

American Paper Institute, Inc.
1619 Massachusetts Avenue, N.W. Washington, DC 20036
(202) 332-1050

NATURAL GAS PRICING

What's The Problem

Wellhead pricing of natural gas is set below the market value due to provisions of the Natural Gas Policy Act (NGPA) which were based on faulty assumptions regarding the 1985 price of oil. These problems are compounded by NGPA provisions calling for only partial decontrol in 1985.

Potential Impact

Unless remedied, the present NGPA will result in continued price disparities, fail to encourage exploration for new gas, discourage conservation and lead to increased oil imports.

Background

Congress passed the NGPA in 1978 as part of the National Energy Act. The NGPA provides for increases in the wellhead ceiling prices of certain natural gas until January 1, 1985, when between 40 to 60 percent of domestic natural gas will be decontrolled. There are 31 categories of natural gas subject to separate price regulation schedules. The Act does not provide for decontrol of "old" gas which will be regulated until its depletion.

The Act also establishes an incremental pricing program whereby certain industrial users pay a surcharge on the regulated price of natural gas. The paper industry currently is exempt from incremental pricing under the agricultural and cogeneration exemptions.

Since petroleum was deregulated in January 1981, natural gas is the only remaining price-regulated fuel.

Our Position

Currently, the industry favors an orderly and predictable transition to decontrol of wellhead pricing of all natural gas and will support policies aimed at achieving this goal. Any deregulation of energy markets should apply equally to all users. The industry believes that incremental pricing is discriminatory and not consistent with a free market mechanism. It is urged, therefore, that incremental pricing be rescinded in order that all users pay according to the cost of service provided.

Others Working On The Problem

Most major industrial groups support phased-in decontrol of all natural gas. Department of Energy officials have indicated support of phased-in decontrol of all natural gas over the 1983-1985 period. The Administration may submit a natural gas decontrol bill to Congress. The bill is expected to include provisions dealing with a schedule for natural gas decontrol ("old" and "new" natural gas), fuel use restrictions, and incremental pricing.

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NATURAL GAS PRICING RESOLUTION

RESOLVED, That ... the officers and staff be and they hereby are authorized and directed to support on an immediate basis the policy position that both old and new supplies of natural gas and petroleum be removed from governmental control, so that market conditions might then determine both allocation and price.

Adopted April 2, 1975
ATMI Board of Directors

The Business Roundtable

POSITION ON NATURAL GAS DEREGULATION

EXISTING FEDERAL REGULATION OF THE WELLHEAD PRICE OF NATURAL GAS SHOULD BE PHASED OUT AS RAPIDLY AS PRACTICABLE AND BY A DATE CERTAIN. THE PHASE-OUT MECHANISM SHOULD ALLOW INDIVIDUAL USERS AND THE ECONOMY AS A WHOLE AN OPPORTUNITY TO PLAN FOR AND ADJUST TO A DEREGULATED NATURAL GAS MARKET.

Natural gas price controls were the primary cause of interstate natural gas shortages in the mid '70s. While keeping gas prices at artificially low levels--thus helping to increase demand by inhibiting conservation--wellhead price controls have also helped to limit supply by dampening gas exploration and production incentives.

The Natural Gas Policy Act of 1978 was intended to begin the process of deregulating the gas market. The NGPA did not immediately deregulate any gas. In fact, it placed price controls for the first time on intrastate gas and left permanently under control a major portion of interstate gas. Wellhead ceiling prices were set for many categories of "new" gas with the intention that they would escalate so as to bring the ceiling price of this gas close to parity with the price of oil by 1985.

However, implementation of the wellhead pricing provisions of the NGPA is not proceeding as intended because of inherent flaws. The part-regulated, part-deregulated structure of NGPA is severely distorting the exploration and development, distribution, and pricing of natural gas in the United States. Although the current recession has created the appearance of a gas surplus, the market distortions remain clear and conditions are being created by these distortions for shortages arising in future years.

The best way to bring natural gas supply and demand into balance is to eliminate as smoothly as possible the market distortions caused by wellhead price controls. Producer sales of natural gas should be set by market forces, free of government restrictions. Without total deregulation of wellhead prices, the pricing differences between the interstate and intrastate markets, as well as among the several interstate markets, will continue to precipitate increasingly severe problems of price and supply disparities. The transition to a true market for natural gas should be accomplished through a phasing out of price controls.

ALL NATURAL GAS CONSUMERS SHOULD SHARE FAIRLY THE BURDEN OF HIGHER GAS COSTS. INCREMENTAL PRICING, MARGINAL COST PRICING, AND OTHER SIMILAR RATE PROPOSALS WHICH SEEK TO IMPOSE A DISPROPORTIONATELY LARGE SHARE OF THAT BURDEN ONLY ON SELECTED CUSTOMERS SHOULD BE REJECTED.

Industrial gas consumers are willing to bear their fair share of higher gas costs, but they are not willing to assume a disproportionately large share of such costs in order to subsidize other gas consumers' rates. American industry needs to remain competitive in today's world markets in order to maintain growing employment in the United States. Since all gas consumers will reap benefits from a healthy, deregulated gas market, all gas consumers should bear their fair share of the costs associated with it.

Rate schemes, such as incremental pricing, and various types of marginal cost pricing should be opposed. The federal incremental pricing program should be terminated by repealing Title II of the Natural Gas Policy Act.

To the extent that decontrol results in increased gas prices which are particularly difficult to absorb among the poor and those with fixed incomes, these problems will be best met through appropriate social policies rather than through energy policies.

NO SO-CALLED WINDFALL PROFITS TAX SHOULD BE LEVIED ON NATURAL GAS PRODUCERS WHEN WELLHEAD PRICE CONTROLS ARE LIFTED.

The concept of taxing away so-called "windfall" profits is fundamentally unsound. Regardless of what categories of gas may be decontrolled at the wellhead--or when they are decontrolled--natural gas producers should be permitted to charge and retain the full free market price of such gas.

Such a "windfall profits" excise tax would mean that decontrol would result in less exploration and production than if there were no excise tax, and therefore higher oil imports and higher oil prices. Moreover, such a tax is unwarranted since under the current tax laws, more than half of the incremental revenue from decontrol would flow to federal, state, and local governments.

ALL OF THE NATURAL GAS ISSUES SHOULD BE SIMULTANEOUSLY ADDRESSED IN ONE CONSISTENT PIECE OF LEGISLATION.

Chamber of Commerce of the United States

1615 H STREET, N.W.
WASHINGTON, D.C. 20062

U.S. CHAMBER OF COMMERCE POSITION ON NATURAL GAS DECONTROL

The Chamber supports decontrol of the price of new natural gas (as defined in the Natural Gas Policy Act of 1978) and of natural gas discovered thereafter, as expeditiously as possible and in no event later than January 1, 1985. In addition, the price of old natural gas (as defined in the Natural Gas Policy Act of 1978) should be decontrolled as expeditiously as possible, by a date certain.

The Chamber supports repeal of incremental pricing and the Powerplant and Industrial Fuel Use Act of 1978 (FUA).

CMA

CHEMICAL MANUFACTURERS ASSOCIATION

Position on Natural Gas Deregulation

The Chemical Manufacturers Association (CMA) is a nonprofit trade association whose company members represent more than 90 percent of the productive capacity of basic industrial chemicals within the country. As the largest industrial consumer of natural gas, CMA members consume over 10 percent of total U.S. natural gas and 25 percent of all industrial gas. Over 50 percent of chemical industry use, approximately one trillion cubic feet per year, is essentially nonsubstitutable. Our members depend upon the intrastate and interstate natural gas systems for supply.

CMA urges Congress to enact, without delay, natural gas deregulation legislation incorporating the following major elements:

- Smooth and orderly phase-up by a date certain of all natural gas wellhead ceiling prices to market clearing levels;
- Coordinated removal of both supply and demand constraints; and
- Free market access for all customers, pipelines and distributors to all categories of gas, including gas from the Outer Continental Shelf.

Timely Congressional action to deregulate natural gas will benefit the nation as a whole with a minimum disruption to the market because:

- The current surplus will help to cushion the impact of the removal of supply demand constraints;
- Deregulation of all natural gas, unifying the interstate and intrastate markets, will contribute greatly toward more rapid development of alternate fuels, overall economic efficiency of fuel use, and greater assurance of adequate future supplies;
- Opportunities for reduced oil imports through price-induced increases in supply of natural gas, and for correlative price-induced conservation by industrial and residential consumers of natural gas, will be the natural result of allowing market forces to begin to operate now, rather than at some indefinite future date.

WAW:pt
8/25/82

cibo
COUNCIL OF INDUSTRIAL BOILER OWNERS

The Council of Industrial Boiler Owners (CIBO) believes that the central goal of national energy policy should be to maximize the reliance on free market mechanisms. To that end, CIBO believes that the government should pursue an aggressive and coordinated program aimed at removing the remainder of the maze of energy regulatory programs which have hampered domestic energy production, unfairly penalized domestic industry, and artifically increased energy demand.

The free market is the most efficient means of encouraging the development of domestic energy supplies and assuring the optimum allocation of these resources. In contrast, government regulation of the price, distribution and use of energy supplies generally has stifled production, artificially increased demand, misallocated resources and led to a seemingly unending array of new regulatory and legislative initiatives, many of which have been instituted to counteract the ill-effects of past regulatory programs. As recognized by the current Administration in its National Energy Policy, experience with these energy programs conclusively demonstrates that they must be replaced with an approach which relies on the free market to achieve sound energy policy.

Consistent with this basic principle, the Council of Industrial Boiler Owners believes that a coordinated approach to removing unnecessary and counterproductive energy legislation should be undertaken. Such an approach should seek, as one of its major goals, to assure true interfuel competition. Among the legislative actions which should be undertaken as part of this coordinated program are the following.

1. Repeal of Title II of the Natural Gas Policy Act of 1978;

2. Orderly phased decontrol of all wellhead price controls over natural gas; and

3. Repeal of Section 202 of the Powerplant and Industrial Fuel Use Act of 1978 and modification of Section 302 to permit prohibition orders to be issued to existing MFBI's only at the request of the owner of the MFBI.

11222 Silverleaf Drive, Fairfax Station, Virginia 22039 • (703) 250-9042

Within this overall framework, CIBO will continuously explore and evaluate opportunities to eliminate all unnecessary and counterproductive energy legislation and regulations.

The Council of Industrial Boiler Owners is a broad-based association of industrial boiler operators and related equipment manufacturers, representing sixteen major industries, independent of public utilities. CIBO was formed in 1978 to encourage the maximum exchange of relevant information among its members and between industry and government to assure that public policy in the fuel utilization and environmental areas is realistic in light of the contribution to our economy of industrial boiler users and their support of the free market.

In order to fill this role, CIBO has adopted the following policy objectives:

- o Advance the Understanding of Differences Between Industrial and Utility Boilers
- o Reconcile and Balance Energy and Environmental Policy
- o Assure True Interfuel Competition
- o Modify the Clean Air Act
- o Encourage Industrial Cogeneration
- o Accelerate Investigation of the Acid Rain Phenomenon.

Highway Users Federation
FOR SAFETY AND MOBILITY

Policy on Energy

American transportation will continue to depend almost exclusively on liquid fuels in the foreseeable future. Ensuring availability of fuels for transportation should be a matter of highest national priority, and requires free market-oriented energy policies to stimulate prompt and cost-efficient development of all energy sources.

The industrial and economic health of the United States, the welfare of our citizens and our national security will benefit from an efficient reduction in our dependence on imported fuels. Government energy policies should make possible increased production of natural gas, crude oil and synthetic fuels.

- As oil price decontrol has provided substantial gains in economic efficiency and energy security to the nation, so would accelerated phased decontrol of all natural gas wellhead price controls.
- Government should reduce legislative and regulatory obstacles to the vital development and production of domestic energy resources and synthetic fuels. Environmental and other conflicts which impede energy program progress should be quickly resolved.
- Special efforts should be made to provide access to more public lands for energy development and to speed the process of approving exploration and development plans once rights have been granted.
- Government should continue to support private sector research and development programs in synthetic fuel production to ensure their timely progress.

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Energy conservation must also have high national priority. Road transportation can and should do its part in reducing energy consumption in proportion with specific goals.

- o Adherence to the 55 MPH speed limit, increased car and vanpooling, use of available public transportation, good vehicle maintenance and improvements to our road system should be encouraged to promote efficient traffic flow.
- o To encourage conservation, ensure responsible allocation and stimulate increased supply, the price of energy to the American consumer should reflect its market value.
- o Broad-based conservation strategies which affect all sectors are preferable to actions focused on specific end users.

The marketplace should be the primary mechanism for the supply and distribution of energy.

- o To deal with the possible adverse affects of any serious energy supply shortfall, contingency plans should be developed. Such plans should recognize the essential fuel and basic material needs of critical segments of the transportation sector.
- o A government owned and operated strategic petroleum reserve should be developed and maintained to help ensure supplies for essential emergency needs.
- o Rationing should be imposed only in an extreme emergency and should continue only so long as that emergency exists.

These energy goals can and should be reached with maximum reliance on the private sector, and without legislative restructuring of the energy industry.

INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA
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WASHINGTON, D. C. 20036
[illegible]

REPORT OF THE

IPAA NATURAL GAS COMMITTEE

OCTOBER 13, 1982

The NGPA was based on the faulty premise that the U.S. is running out of natural gas. As a result, the Act is operating to drastically distort both supply and demand prices. Those distortions are leading to higher prices to consumers and lower revenues to producers.

President Reagan has repeated his intention to propose legislation leading to full decontrol of natural gas at an early date. He also is on record as being opposed to any windfall tax on natural gas. We commend him on both positions.

Because of the ever-increasing distortions being created by the NGPA, independent producers support the following actions:

* Decontrol all natural gas at the earliest possible date by repealing pricing provisions of the NGPA and amending the Natural Gas Act without the addition of any new production taxes;

* Repeal the Fuel Use Act and incremental pricing provisions of NGPA;

* Establish a natural gas import policy which does not encourage imports as a replacement for domestically produced gas.

In addition, to assure that maximum competitive forces work in both the producing and consuming sectors of the gas industry, a review should be made of laws and regulations to insure that pipelines, as a unique transportation system, do not exert a monopolistic influence over either the sale or purchase of natural gas.

We urge the President and the leaders of the 98th Congress to move early in 1983 to accomplish these goals. We believe that, as in the case of oil decontrol, this action would benefit consumers and producers alike.

NAM

NATURAL GAS DEREGULATION

The National Association of Manufacturers (NAM) strongly believes that current natural gas policy and regulation benefits neither users, producers, or the nation at large. The Natural Gas Policy Act of 1978 (NGPA) has clearly failed to meet the legislative intent of the Congress and its overall deficiencies will become even more apparent in the near futre. The Fuel Use Act (FUA) and the incremental pricing provisions of NGPA have introduced wide-spread inefficiencies and market disorder. NAM believes that the free-market, rather than the federal government, is the most efficient allocator of scarce resources.

In March of 1981, the NAM's Board of Directors, consisting of this nation's leading industrialists and representing virtually every segment of American industry, overwhelmingly approved (by a vote of 170 to 6) a policy supporting the total deregulation of all natural gas in a phased manner by 1985. Included in that policy is support for repeal of the Fuel Use Act and repeal of incremental pricing under Title II of the NGPA.

Pending before the Congress is Representative Gramm's H.R. 5866, the Natural Gas Production, Utilization, and Conservation Act of 1982 and Senator Johnston's S. 2074, the Natural Gas Production and Market Adjustment Act of 1982. The NAM Energy Committee's Fossil Fuels Task Force met early the year to review both Representative Gramm's and Senator Johnston's proposals and overwhelmingly endorsed their priciples and objectives.

The NAM believes that total, phased natural gas deregulation makes good energy policy and that it must be accomplished now. The NAM urges Congress to forge a legislative consensus now on this issue, before the disastrous effects of NGPA, FUA and incremental pricing further reduce our national energy security and our economic well-being.

NATIONAL CATTLEMEN'S ASSOCIATION
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National Headquarters
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TAXES-EXCISE TAX ON NATURAL GAS PRODUCTION

WHEREAS, As it is in the national interest to fully develop our natural gas reserves and to make available to this nation this clean and efficient source of energy; and

WHEREAS, The imposition of a windfall profits tax would discourage exploration and development of this valuable resource;

THEREFORE, BE IT RESOLVED, NCA oppose the enactment by the U.S. Congress of an excise tax, such as the "Windfall Profits Tax," on natural gas production.

ENERGY-CONSERVATION AND DEVELOPMENT

WHEREAS, The Nation has failed to develop a supply of energy at a rate commensurate with the growth of its needs; and,

WHEREAS, That failure has led to a dependence upon foreign sources to meet essential peacetime needs; and,

WHEREAS, The President of the United States has called upon the Nation to achieve self-sufficiency in energy sources and supplies; and,

WHEREAS, The vitality of Agriculture and the economy of the Nation requires adequate energy for the production, processing and distribution segments of the industry, thus imposing the gravest of responsibility to achieve the most effective possible use of available energy; and,

WHEREAS, The most efficient use of energy resources will be dictated finally by a free market rather than by government edict;

THEREFORE, BE IT RESOLVED, That we, the members of NCA, dedicate our organization, ourselves and our individual operations to support reasonable and effective national programs of energy conservation; and,

BE IT FURTHER RESOLVED, That the NCA vigorously urges all people engaged in livestock production everywhere to work and cooperate with those local, state and federal officials charged with implementing the energy conservation program; and

BE IT FURTHER RESOLVED, That the Association urge the Federal Government to stimulate, within the confines of free enterprise, the rapid and adequate development of all domestic sources of energy, remove governmental impediments to the development of a healthy energy industry, and provide a business climate which will attract the vast reservoir of private capital necessary to expeditiously attain energy self-sufficiency for America.

NATIONAL COAL ASSOCIATION

ALL ENERGY SOURCES SHOULD BE COMPETITIVELY PRICED

The National Coal Association has supported the deregulation of energy prices for many years because we believe the national interest is best served when there is healthy competition in the marketplace.

NCA also supports the rapid and assured deregulation of natural gas at the wellhead. Gas is the only fuel still receiving preferential treatment by the federal government. So long as this practice continues it is impossible for energy users to make the proper economic and energy planning decisions and this is to the detriment of the industries and consumers alike. This atmosphere of uncertainty clearly is at the root of our economic energy problems over the past decade.

Coal is this nation's most abundant and lowest-cost fuel. As such, coal has great potential as a fuel in new electric utility and industrial plants and as a substitute for gas and far costlier imported oil in the industrial sector. Imported oil continues to fuel inflation and erode the nation's balance of payments. It is fraught with foreign policy implications.

Coal can be the catalyst for providing this nation with an ample supply of reasonably priced energy in the years ahead. Unless coal can compete equally with all fuels in the energy markets, these goals will be frustrated.

Natural gas prices have been artificially controlled since 1954 following the Supreme Court decision in the Phillips Case. Over the years, each attempt at deregulation has been spurned based on the logic that natural gas could be supplied forever and that a low price always was in the best interest of consumers.

Instead, we saw gas shortages, market dislocations and distortions during the 1970s, resulting in the National Gas Policy Act in 1978 (NGPA). The NGPA:

- Placed previously unregulated intrastate gas under federal price controls; and
- Provided for the gradual escalation of the price ceilings for newly discovered and most flowing intrastate natural gas after 1978 and for removal of the ceilings on January 1, 1985.

Phased deregulation is to be accomplished by escalating the ceiling price on newly discovered natural gas and natural gas flowing in the former intrastate market from 1978 to 1985 to a level higher than the Btu equivalent price of crude oil. This latter price has been assumed as a rough approximation of the long-term clearing price for natural gas under decontrolled conditions. The price is equivalent to about $15/bbl for crude oil, which was higher than the $12-13/bbl then being paid for imported crude oil landed on the U.S. coast when the NGPA was being developed in 1978.

Consequently, with crude oil priced at $30/bbl or more, phased deregulation can be expected to lead to:

- Sharp price increases in 1985, especially in the Southwest;
- Regional shifts of available natural gas supplies away from the Southwest;
- Possible reduced supplies of newly discovered gas prior to 1985 and consequent curtailments in the interstate market.

These conditions will not make deregulation of natural gas supplies in 1985 any easier. Indeed, if past experience is a guide, abrupt increases of wellhead prices will not be permitted and the accompanying market disorders will create irresistible political pressures to extend price controls on natural gas beyond 1985.

This we do not believe is in the national interest, and clearly flies in the face of recent decontrol experience. The most striking results can be seen from the total decontrol of domestic crude, gasoline and propane that took effect in January 1981. We now see much greater price stability, a reversal of oil shortages so common in recent years and an increase in drilling for new oil supplies, only recently tempered by the recession. Decontrol is giving the American consumer a greater incentive to conserve oil, particularly in the transportation sector.

With natural gas deregulation we can add more pricing stability, provide an incentive for more gas exploration, and build in the incentive for industries and utilities to replace older, less efficient oil- and gas-fired plants with more efficient and productive coal-fired plants. We also can put behind us the ineffective system of allowing the government to make production, pricing and allocation decisions for the consumer.

The National Coal Association believes this nation needs more competition, not less. A system that stimulates risk-taking and investment always will be in the national interest.

August 23, 1982

national grange

1616 H STREET, N.W. WASHINGTON, D.C. 20006 (202) 628-3507

GRANGE

DOMESTIC ENERGY DEVELOPMENT

WHEREAS, a secure and adequate energy supply is essential to our National security, our agricultural production, economy and the general welfare, and

WHEREAS, domestic energy development has been hampered by excessive government regulations, keeping us more dependent on foreign oil; therefore, be it

RESOLVED, that the National Grange support increased development of all forms of domestic energy resources in an environmentally sound manner, including the repeal of laws and regulations that have blocked or discouraged U.S. energy production, especially by private enterprise; and be it further

RESOLVED, that the National Grange encourage energy conservation, in agriculture, in industry, in commerce and in the home by the use of tax credits and incentives, but not by penalizing those who have made use of our surplus energy in the past and thereby kept our energy costs low.

National Oil Jobbers Council
1707 H Street, N.W., 11th Floor
Washington, D. C. 20006 · 202/331-1198

Representing
Member
Associations in:

Alabama
Arizona
Arkansas
California
Colorado
Connecticut
Delaware
District of
Columbia
Florida
Georgia
Idaho
Indiana
Iowa
Kansas
Kentucky
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New Hampshire
New Jersey
New Mexico
New York
North Carolina
Ohio
Oklahoma
Oregon
Pennsylvania
South Carolina
South Dakota
Tennessee
Texas
Utah
Virginia
Washington
West Virginia
Wisconsin
Wyoming

NATIONAL OIL JOBBERS COUNCIL POSITION ON NATURAL GAS DEREGULATION

The National Oil Jobbers Council (NOJC) supports the immediate and total deregulation of natural gas. The small business heating oil dealer must compete against the natural gas utility, whose product is artificially priced well below its true market value by the Natural Gas Policy Act (NGPA). The NGPA effectively legalizes predatory pricing, forcing hundreds of heating oil dealers out of business and seriously jeopardizing the fuel distribution system. Because petroleum, natural gas and coal are our prime sources of energy, energy policy should promote the efficient use of these fuels by allowing them to compete in the market priced according to their merits. Only with a consistent policy which efficiently utilizes all our energy resources at their true costs will we be able to obtain energy security and best serve the needs of the consumer.

The artificial subsidization of natural gas prices discriminates against the 16 million residential consumers of home heating oil throughout the country who are paying full price for their energy needs. Home heating oil consumers have been meeting the challenge of higher energy costs through more efficient use of the energy they purchase. Meanwhile, their neighbors using natural gas continue their wasteful consumption of a nonrenewable energy resource because natural gas is priced below its true value. To the consumer, the value of a fuel is not only the cost of the fuel itself, but the value of the warmth it provides. The value of this warmth is the same, no matter the source. The preferential treatment of the residential user of natural gas is grossly unfair to those consumers who heat their homes with electricity or heating oil.

A Federation of Independent Petroleum Marketers Founded in 1941
Merged with the National Oil Fuel Institute in 1974.

NATIONAL PETROLEUM REFINERS ASSOCIATION
Founded 1902
SUITE 1000, 1899 L STREET, N.W., WASHINGTON, D.C. 20036
TELEPHONE (202) 457-0480

NPRA NATURAL GAS POLICY

The National Petroleum Refiners Association supports the removal of price and demand constraints on natural gas as soon as practicable.

The membership of the NPRA includes nearly every large and small company engaged in petroleum refining and petrochemical manufacture in the United States. These companies are consumers, distributors and producers of gas for both fuel and process feedstocks, and, therefore, are vitally concerned with the adequate supply and efficient use of natural gas in the United States.

Control of natural gas pricing and demand by the NGPA, the NGA and the FUA have not produced the desired objectives of increased gas supply, diminished demand, and an orderly market. Total decontrol of the wellhead ceiling price constraints in order to promote the most economic development of the nation's gas resources and removal of artificial demand constraints to ensure the most efficient use is in the best interests of the nation and its refining and petrochemical industries.

The general principles of natural gas decontrol which we support are:

- phase-up of all natural gas wellhead ceiling prices to market levels.
- the complete removal of all supply and demand constraints on natural gas by January 1, 1985.
- allowance for all consumer, pipeline and distributor access to a free market for all categories of gas, including gas from the Outer Continental Shelf.
- the removal of all demand constraints includes, but is not limited to, the repeal of the Fuel Use Act and the incremental pricing provisions of the Natural Gas Policy Act.
- immediate decontrol of prospectively discovered gas.

The NPRA opposes the enactment of any excise or so-called windfall profits tax in connection with the removal of controls over natural gas. Such a tax would dilute the much needed favorable supply response which sound national energy policy requires.

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NPRA

The membership of the NPRA includes nearly every large and small company engaged in petroleum refining and petrochemical manufacture in the United States. These companies are consumers, distributors and producers of gas for both fuel and process feedstocks, and, therefore, are vitally concerned with the adequate supply and efficient use of natural gas in the United States.

February 4, 1982

NATURAL GAS SUPPLY ASSOCIATION

1730 Rhode Island Avenue, N.W.
Suite 200
Washington, DC 20036
(202) 331-8900

Policy Statement

The evidence is now overwhelming that the Natural Gas Policy Act of 1978 is a failure as an instrument of national energy policy. It is acting as a disincentive to exploration, it is promoting misapplication of resources by both producers and consumers, it is grossly distorting natural gas markets. These effects are clear today and their impact can only worsen.

We strongly urge Congress to begin immediately the task of fashioning a workable solution. Precious legislative time has already been lost. Any further delay - certainly a delay beyond 1983 - is likely to create a situation for which the only remedy will be Government-managed curtailments, rationing and entitlements.

Reasonable minds may differ as to the details of legislative language but the core of any solution to NGPA's mischief is the complete removal of well-head price and production controls by a date certain. The furthest date which should be considered is January 1, 1985.

The producers of natural gas oppose the concept of any excise or so-called windfall profits tax. The debate over Federal revenue or taxing policies, however, should not be used as a reason for delay in addressing and achieving sound national energy policy for natural gas.

Representing the Nation's Producers of Natural Gas

The Petrochemical Energy Group
1701 Pennsylvania Avenue, N.W.
Washington, D. C. 20006
(202) 452-1880

NATURAL GAS DEREGULATION

The Natural Gas Policy Act (NGPA) has already caused unstable natural gas markets. It may result in chaos in these markets by 1985 if not sooner. The remedy should address the causes of the condition, not the symptoms generated by the causes. Piecemeal "fixes" are not likely to help, particularly fixes which regress toward imposition of more and more federal government controls. The Petrochemical Energy Group (PEG) believes removal of federal gas supply controls including price, allocation, and contract controls offers the best hope for the nationwide gas situation. Moreover, federal gas demand controls, including incremental pricing and the Fuel Use Act, should be eliminated as part of this comprehensive resolution of the natural gas problem based on returning to market forces and abandoning federal regulation.

Specifically, the NGPA should be amended to accomplish the deregulation of all wellhead sales, not only as to price controls, but also as to federal controls which allocate gas to a particular pipeline or to a particular market, such as abandonment requirements, rights of first refusal, minimum contract duration, and preferential access to Outer Continental Shelf gas. It is essential that total decontrol occurs on a single date certain, not piecemeal on two or more dates. Thus, a phased decontrol schedule, even with earlier deregulation in whole or in part of new wells, should reach a single target date on which controls terminate; one or more categories of gas should not have a different target date. The objective should be to bring the average price of gas at the wellhead to a market clearing level and to eliminate all "cushions" caused by price ceiling controls for all gas on the single target date for decontrol.

If these objectives are met by legislation, then demand controls, such as incremental pricing and Fuel Use Act restrictions, should also be eliminated.

The goal should be to assure consumers in any State that they or their suppliers will have equal access to all gas supplies in the fields, wherever they are, subject only to contracts and fair competitive considerations, but not subject to the whims of federal regulation.

PEG is an ad hoc group of 16 independent U.S. petrochemical producers, independent in that they are not owned or controlled by any of the integrated oil companies. PEG members include both large and small companies, but among the key characteristics all share is the fact that none produces or refines a significant percentage of its own raw materials. For the most part, PEG companies purchase hydrocarbon raw materials--oil, naphtha and gas oils, natural gas liquids, and natural gas--from the companies that produce, refine, and transport energy products; or, these materials are imported directly from abroad.

The petrochemical industry plays a major role in the U.S. economy and makes a major contribution to the positive side of the U.S. balance of trade. In 1979 our industry's positive balance of trade was $8.4 billion. In 1980 it was $9.4 billion. Typically U.S. exports of petrochemical and petrochemical dependent products constitute nearly 39 percent of all U.S. exports. In addition, 35-45 percent of overall U.S. business activity is directly and indirectly dependent on the U.S. petrochemical industry, as measured by employment, capital investment, taxes and sales.

June 1982

PGC
PROCESS GAS CONSUMERS GROUP • SUITE 800/1666 K STREET, N.W.
WASHINGTON, D.C. 20006
202 872-9349

PROCESS GAS CONSUMERS GROUP POSITION ON NATURAL GAS LEGISLATION

The Process Gas Consumers Group (PGC) is an association of industrial companies which use natural gas in processes for which there is no economically or technically feasible substitute for gas. Our membership includes fifteen companies in a wide range of industries operating more than 800 plants in virtually every state in the Nation. PGC members purchase natural gas directly or indirectly from both interstate and intrastate pipelines, with most of our facilities on the interstate system.

While the range of uses in which PGC members use natural gas is quite broad, PGC's views with respect to natural gas issues reflect primarily its members' use of natural gas in industrial processes in which alternate, non-gaseous fuels cannot feasibly be utilized. From this perspective, there are two paramount natural gas issues: (1) security of supply and (2) price. The latter issue encompasses not only price levels vis-a-vis alternate fuels, but also the effects of pricing policies and rate design on the relative rates paid by various classes of gas consumers.

Given the glowing reports emanating from some quarters about plentiful gas supplies, PGC's concern with supply security may seem to some to be unwarranted. However, our concern is with sufficiency of supply to meet long-term needs in a hopefully stabilized energy market. We are not convinced that, under the unstable conditions fostered by existing laws, the current surpluses are anything more than a short-term phenomenon. We vividly remember the acute gas shortages of the mid-1970s; industrial users were among the worst victims of those shortages as plants were closed, employees were laid off, and operations were severely disrupted.

PGC's other paramount concern with respect to gas is its price. While we are no more anxious than anyone else to see our gas bills increase, we are willing to pay true free-market prices for gas and anticipate that such prices will be more stable -- and perhaps even lower in the long run -- than would be the case under the Natural Gas Policy Act ("NGPA").

Thus, PGC believes that wellhead price controls must be phased out if supply and demand in the gas market are ever to be brought into balance. However, while we are willing to pay free market prices for gas, we are strongly opposed to (1) paying prices higher than those which would be commanded in a truly free market, and (2) paying a disproportionate share of higher gas costs so that other gas consumers can be subsidized, such as through incremental or marginal cost-based pricing schemes.

As consumers, we are concerned about the impact of higher gas prices on our businesses, our customers, and our employees. We seek adequate gas supplies at reasonable prices -- a goal which, in our opinion, may not be fully achieved under the NGPA in its current form. Artificially-low prices are not welcome if they mean -- as they have in the past -- inadequate or unstable supplies. Under these circumstances, we believe it to be in our interest -- and in the interest of all gas consumers -- to understand the need for and support the following positions as a basis for balanced legislative and regulatory action:

(1) Wellhead price controls on natural gas should be phased out and discriminatory restraints on gas use, such as incremental pricing and the Fuel Use Act, should be eliminated.

(2) Natural gas rates to distributors and end-users should be based on cost-of-service principles.

(3) Pipelines and utilities should be permitted an opportunity to earn a fair return on investment.

(4) Restrictions on the attachment of additional customer load should continue unless a utility can demonstrate that it has adequate, proven gas supplies to serve the new load for a reasonable period without jeopardizing service to existing load.

(5) Natural gas curtailment plans should be based on the technical and economic feasibility of converting various end-users of natural gas to alternate fuels; accordingly, high-priority treatment of process and feedstock uses should be a feature of all natural gas curtailment plans.

(6) Efforts by industrial gas consumers to obtain supplemental supplies (self-help gas) should be encouraged.

SpecialBulletin

The Society of the Plastics Industry, Inc., 355 Lexington Avenue, New York, N.Y. 10017 • (212) 573-9400

July 23, 1982

SPECIAL ISSUE BRIEFING: NATURAL GAS DEREGULATION

Action Required

THE ISSUE IN BRIEF

The Natural Gas Policy Act of 1978 provides that approximately 50% of the nation's natural gas supply will become deregulated on January 1, 1985, while price controls will continue over the gas being produced from certain older fields. Because of a number of economic distortions and inequities that are expected to result from partial deregulation, the plastics industry and most other industries dependent upon natural gas believe total deregulation is in the nation's best interest. For the plastics industry, deregulation would eliminate arbitrary government regulations that interfere with feedstock supplies. Congress has begun examining the issue and legislative action is anticipated by early 1983.

BACKGROUND

The Natural Gas Policy Act of 1978 (NGPA) was passed after a prolonged effort to remove controls over the wellhead price of natural gas sold in the interstate market. The controls had been imposed and administered by the Federal Power Commission and then by its successor agency, the Federal Energy Regulatory Commission. The 1978 law, while heralded as deregulating natural gas, actually perpetuated and extended controls in some ways. Principally, under the NGPA:

1. The wellhead price of some "newly discovered" natural gas (after 1977) is decontrolled as of January 1, 1985, but the President of Congress can reimpose controls for 18 months. This reimposition authority expires June 30, 1987. The price of other gas, about half of that currently being produced, would remain under controls.

2. Until January 1, 1985, the price of newly discovered natural gas is permitted to rise gradually each year according to a specific formula. The formula was intended to create parity between gas and oil prices by the time of decontrol.

3. The concept of incremental pricing was established, directing that the increased cost of gas resulting from higher prices would be borne by industrial users, particularly those using gas for boiler fuel.

4. Controls were extended to include gas sold to intrastate pipeline systems that previously had been subject to free market forces in the pricing of gas.

Those who originally favored total decontrol of gas prices have continued to press for additional congressional consideration of the gas issue. As the price of oil has escalated far beyond what the NGPA price increase formula contemplated ($16 per barrel by 1985), it has further underscored the need for a fresh look at the question of natural gas pricing.

PLASTICS INDUSTRY INTEREST AND POSITION

Natural gas is the principal source of feedstock for some of the plastics industry's principal resins, including low and high density polyethylene and polyvinyl chloride. It is also invaluable for process use in a number of plastics manufacturing operations, including film conversion, coating, and decorating. It is in the plastics industry's interest that existing and potential supplies of raw materials be maximized to the extent possible. The Natural Gas Policy Act of 1978 (NGPA), by perpetuating controls for older gas and creating inequities between interstate and intrastate pipelines, as well as between different interstate pipelines, creates distortions in the reliability of future supplies, particularly for such petrochemically-based industries as plastics.

1. The removal of all wellhead price controls on natural gas will encourage producers to explore for more gas, thus maximizing future supplies. The experience of oil decontrol has demonstrated the positive longer-term effects upon supply and price that occur in a free market.

2. Under the NGPA, pipelines with a "cushion" of cheaper, controlled "old" gas, will be in a position to bid up the price of the newly deregulated gas excessively high, perhaps above the price of oil. Experience with a category of gas under NGPA that is already free of controls strongly suggests this bidding pattern will occur.

3. The NGPA's incremental pricing provisions, which require industrial users to pay higher costs for deregulated gas in order to minimize price increases for residential consumers, will continue after 1985. This provision could be extended to include feedstock and process use.

4. Several features of NGPA create a bias against intrastate pipelines, which serve most petrochemical plants. Many petrochemical companies have indicated that under existing law this bias will make it more difficult for intrastate pipelines to bid for natural gas. Pipelines should be able to compete for supplies without government-created advantages for some over others.

The SPI believes all sources of energy should be priced according to market forces. The NGPA should be amended so that natural gas wellhead price controls and other government policies inhibiting supply are removed by a date certain.

CURRENT STATUS

President Reagan has previously indicated support for natural gas deregulation, but announced on March 1 he would not request Congress to act this year. Nonetheless, the Senate Energy and Natural Resources Committee held two days of background hearings on the subject of natural gas in late March, and the House Fossil Fuels Subcommittee is holding similar hearings in late Summer. While additional legislative activity is not expected in 1982, early consideration of the issue in 1983 is probable. Major bills pending that would phase-in total deregulation over a two year period are H.R. 5866 (Gramm, D-TX) and S. 2074 (Johnston, D-LA and Long, D-LA).

ACTION NEEDED

The need for Congress to amend the Natural Gas Policy Act and provide for compelte deregulation should be communicated to Members of Congress, as well as to candidates for Congress, during the remainder of 1982. Early consideration of the issue in 1983 should be urged.

FOR FURTHER INFORMATION, CONTACT THE SPI WASHINGTON OFFICE. Telephone: 202/298-7200.